MSSP

Market Segment Specialization Program

Rehabilitation Tax Credit

The taxpayer names and addresses shown in this publication are hypothetical. They were chosen at random from a list of names of American colleges and universities as shown in *Webster's Dictionary* or from a list of names of counties in the United States as listed in the *United States Government Printing Office Style Manual.*

This material was designed specifically for training purposes only. Under no circumstances should the contents be used or cited as authority for setting or sustaining a technical position.

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Internal Revenue Service

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Chapter 1

INTRODUCTION

GENERAL BACKGROUND REGARDING CREDIT

The Rehabilitation Tax Credit was made a part of the Federal tax system starting with the Tax Reform Act of 1976. In general, the first legislated incentive to encourage the preservation of "historical buildings" as a 5 year quick write-off. The quick write-off was enhanced to a 10 percent credit in 1978. In 1981, Congress determined that, because of the success of the Rehabilitation Tax Credit as an incentive for buildings which were deemed to be "historical," the concept of tax credits as an incentive to rehabilitate property would be extended to non-historic buildings by virtue of their age. The credit was expanded to a three tier credit; a 25 percent credit for "historic rehabilitations," a non-historic rehabilitation credit of 20 percent for buildings at least 40 years old, and a 15 percent credit for buildings at least 30 years old.

Even in the climate of the Tax Reform Act of 1986, the rehabilitation Tax Credit was one of the few surviving tax incentives, as preserved by Congress, to shape public policy regarding the preservation and rehabilitation of both "historical" and older buildings. The credit was retained as a two-tier credit with a 20 percent credit available for historical buildings and a 10 percent credit for non-historic buildings which were first placed in service before 1936.

Based on the 1992 Fiscal Year Report of the National Park Service, approximately 25,000 projects have been completed since the credit's inception in 1976. Over $16 billion in investment has been yielded by this credit program, and its tremendous effects are evident in not only the major cities in the United States, but also in many small towns and communities throughout the country. As indicated in the National Park Service Fiscal Year Report, "the use of Federal tax incentives to encourage private investment in historic rehabilitation has been one of the most effective Federal programs to promote both urban and rural revitalization *** the completed projects have brought renewed life to deteriorated business and residential districts, created new jobs and new housing units, increased local and state revenues, and helped ensure the long-term preservation of irreplaceable cultural resources."

Although the number of projects per year and the aggregate investment per year had been on the decline since the Tax Reform Act of 1986, there was an increase in the number of projects in 1992. Over 700 projects were started with a projected investment of $491 million, and the National Park Service certified prior projects having an aggregate investment of $777 million for 650 buildings. The effects of the passive activity restrictions has impacted the use of this credit in terms of both numbers and the character of the users. In more recent years, the credit has shifted from its predominate appearance in partnerships and the related flow-through investors, to a C-Corporation and individual owner profile. Then, with the emergence of the "Low Income Housing" credit, there has been a dramatic increase in projects with the intent to both rehabilitate historical or non-historical buildings and create affordable housing. Such projects can qualify for both credits.

BACKGROUND REGARDING PHILADELPHIA DISTRICT PROGRAM

The Philadelphia District started a program to coordinate and examine rehabilitation credit cases in 1986. Since that time, the program has grown in both magnitude and scope. While initially starting with approximately 20 cases, the program has expanded to include the audit of several hundred cases. Many of these cases have reflected credits from projects with expenditures ranging from $1 million to $50 million.

Early in the program, a line of communication was initiated with the National Park Service (NPS) and that contact has opened the door to hundreds of hours of coordination between the two agencies. After years of using NPS hard copy records in open examinations, the Philadelphia District Office downloaded the computer system of the Mid-Atlantic Regional Office of the National Park Service in 1992. This download has extracted records for 14,000 projects which can be used by 22 districts in the eastern part of the country. The information from the National Park Service can be used not only to check on specific projects, but also to design the framework for a coordinated approach to identify and audit cases exhibiting rehabilitation tax credits.

In addition to the National Park Service coordination described above, Philadelphia also coordinated with the State Historic Preservation Office in Harrisburg, Pennsylvania. This contact also has been very productive in that many hours of assistance have been provided to our examiners working rehabilitation tax credit cases.

Philadelphia District has produced audit guides such as an issue check sheet (see Exhibit 1–1), pro forma Information Document Requests (see Exhibit 1–2), and standardized audit reports to address common rehabilitation tax credit issues, as well as other audit aids which can reduce time on cases while assisting examiners to focus on the significant issues. This Market Segment Specialization Program (MSSP) guide incorporates these audit items and includes the experience which has been generated not only by the several hundred cases as examined by the District, but also based on another facet of this coordinated approach.

Shortly after beginning this program, the Philadelphia District started receiving calls from throughout the United States. Since 1986, over 7,000 calls have been fielded from project owners, developers, syndicators, consultants, architects, accountants, attorneys, preservationists, real estate professionals, and personnel from the National

Park Service, the State Historic Preservation Offices, and local government planners. Questions answered included brief contacts with quick questions, as well as contacts involving conference calls with large corporations or real estate concerns. These callers have not only received a high level of taxpayer service, but have also assisted our personnel by exposing them to thousands of practical real world situations involving rehabilitation projects. In response to the needs, as surfaced by our outside contacts, Philadelphia District has conducted approximately 75 public speaking engagements and produced an extensive brief presenting the rehabilitation credit law sections in a topical issue format. To date, several thousand of these briefs have been sent to callers throughout the United States.

LEGISLATIVE HISTORY

Before 1976, there were no incentives for restoring or rehabilitating older buildings in our Nation's tax laws. Prior law actually encouraged the destruction of these buildings by allowing deductions related to their demolition. In addition, the erection of newer buildings in their place benefitted from quicker depreciation methods.

The year 1976 was the first year that Congress endeavored to shape public policy regarding the preservation and rehabilitation of older buildings through our Nation's tax laws. The Tax Reform Act of 1976 made four major law changes regarding the treatment of deductions in reference to older buildings. These law changes became a foundation for the current tax provisions regarding rehabilitation.

1. A provision to allow a 5 year "quick write off" (amortization) of rehabilitation expenditures. (Costs except land and original shell).

2. Alternative to the above which allowed for accelerated method of depreciation to be used on both the shell and rehabilitation costs.

3. A provision which allowed only a straight-line method of depreciation on any new building constructed where an older building had been demolished.

4. A prohibition against any deduction or recognition for tax purposes of any costs for demolition or site clearing and no deduction for the purchase price of the property, (building before demolition).

The next tax change, the Revenue Act of 1978, brought about an additional incentive in the form of a tax credit. This tax credit, at a rate of 10 percent, was available in place of the 5 year amortization from the 1976 Tax Act. Congress believed that a credit at a rate of 10 percent, similar to the Investment Tax Credit, would be more attractive to owners or investors than amortization or depreciation deductions.

In 1981, the Economic Reform Tax Act brought about the most substantial tax credit incentives for rehabilitation to date. In addition to historical buildings, the new law also recognized older non-historical buildings, and allowed credits to rehabilitate buildings at least 30 years old. The credits for rehabilitation were in a three tier system as outlined below:

1. Buildings at least 30 years old were allowed a 15 percent credit for qualifying rehabilitation expenditures.

2. Buildings at least 40 years old were allowed a 20 percent credit for qualifying rehabilitation expenditures.

3. Qualifying rehabilitation expenditures for a "Certified Historic Rehabilitation" were allowed a 25 percent credit.

The next change affecting the rehabilitation provisions came as part of the Tax Reform Act of 1986. This Tax Reform Act was one of the most comprehensive and sweeping changes in our Nation's history. Although many deductions and most credits were eliminated, the Rehabilitation Credit provisions were retained with only minor modifications. The credit is now a two-tier credit as outlined below:

1. A 10 percent credit available for rehabilitations of non-historic buildings with an additional requirement that the building must have been originally constructed before 1936. (Non-Historic Rehab Credit).

2. A 20 percent credit available for the rehabilitation of a Certified Historic Structure, (one listed on the National Register of Historic Places or located in a Registered Historic District and determined to be of significance to the Historical District). (Historic Rehabilitation Credit).

The actual law provisions surrounding this two-tier credit, as enacted by the Tax Reform Act of 1986, are very similar to those under prior law. Many of the principles regarding the application of the law and Congress' intent date back to the original law to preserve historical buildings as enacted in 1976.

The most recent change affecting the Rehabilitation Tax Credit was a provision of the Revenue Reconciliation Act of 1990. This change only slightly altered the content of prior provisions by moving the location of the provisions from IRC section 48(g) to IRC section 47.

PASSIVE ACTIVITY RULES

With the Tax Reform Act of 1986, there were other law changes not directly related to the rehabilitation credits. One of these changes, the "Passive Activity Provision" was intended to stop "abusive tax shelters" which had plagued our tax system over the last 20 years. Although not directly related, these changes have impacted on the availability of the credit to certain investors. Because of these changes, limited investors are generally restricted to $7,000 of credit per year, and investors with adjusted gross income over $250,000 may be totally precluded from taking any credits or deductions. The main effect of the Passive Activity restrictions has been a significant change in the character of the users from the partnership form to other forms of ownership.

There have been several proposals to alter the passive activity restrictions in regard to rehabilitation credits. The most notable of these proposals has been captioned, "The Community Revitalization Act." This provision would liberalize the Passive Activity Rules where Rehabilitation Credits are concerned. For example, the $7,000 per year limit would be changed to $20,000 per year with additional credits allowable relative to a taxpayer/owner's situation (20 percent of any excess tax liability over the initial $20,000 credit).

Any legislation which would restore investors' ability to use rehabilitation credits will probably result in an increased number of projects. This potential increase would be due to the fact that the"Rehabilitation Industry" had built a significant investor base prior to the Tax Reform Act of 1986 via the partnership investment vehicle. After the Tax Reform Act of 1986, this base of investors was almost completely eliminated because of the passive activity restrictions. The industry has been gradually rebuilt based on a new character of investors including corporations, individual owner occupied businesses and particularly, the low income housing projects to create affordable housing. If any legislation is enacted which reduces or eliminates the effects of the passive activity restrictions, the industry would be reopened to all types of investors.

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REHABILITATION TAX CREDIT CHECK SHEET

Chapter 3	CERTIFIED HISTORIC REHABILITATION CREDIT PRIOR TO TRA 86 - 25% TRA 86 CREDIT - 20% **Also Note Transition Rules Treas. Reg. § 1.48-12(a) <u>Applicable Law:</u> IRC § 47(c) (2) (B) & (C) IRC § 47(c) (3) Treas. Reg. § 1.48-12(d) Treas. Reg. § 1.48-12(d) (7) (i) Treas. Reg. § 1.48-12(d) (7) (ii) Treas. Reg. § 1.48-12(d) (2) to (6) Anderson Case Dennis Case Girgis Case *Prior to 1991: IRC § 48(g) contains similar provisions	<u>Two certifications are necessary:</u> <u>Certification of the Structure</u> Must be a "Certified Structure" or located in a historical district and contribute to the significance of the district. This is only a prerequisite to potentionally qualify for the rehabilitation credit as outlined below. <u>Certification of the Rehabilitation</u> Additionally, the rehabilitation must be a "Certified Rehabilitation" as certified by the Dept. of Interior/National Park Service. Must have an approved Part III certification from the NPS. Note, review of the Parts I, II and III applications along with the project folder at the National Park Service can be helpful to develop and support many issues. NOTE: If a project lacks certification from the NPS, the credit should be disallowed in the year taken. Also note that the Phila. District has developed a position which can be used on cases lacking certification even if the 3 year statute is barred. This position will be supported by National Office Counsel. See Chapter 3.
Chapter 4	NON-HISTORIC CREDIT Prior to TRA 86 - 20% CREDIT (40 YR BLDG) 15% CREDIT (30 YR BLDG) TRA 86 - 10% CREDIT ** Also Note Transition Rules Treas. Reg § 1.48-12 (a) <u>Applicable Law:</u> IRC § 47 (a) (1) IRC § 47(c) (1) IRC § 47(c) (2) (B) & (C) Treas. Reg. § 1.48-12(d) (1) to (6) Treas. Reg. § 1.48-12(c) (7) (iv) Treas. Reg. § 1.48-12(b) (3) to (5) Bailey Case Depot Investors Case Girgis Case Nalle Case *Prior to 1991: IRC § 48(g) contains similar provisions.	<u>Prior to TRA 86, Non-historic Credits were as follows:</u> For 20% credit, Must be 40 year old bldg. For 15% credit, Must be 30 year old bldg. Non-historic credit after TRA 86 changes: Under TRA 86 the building must have been originally built before 1936. Certification by the Dept. of the Interior is not required. NOTE: If the property is in a certified historic district, then it must receive <u>DECERTIFICATION</u> from the Dept. of the Interior that the building is not of significance to the district. If NO decertification, then no credit is allowable. Also, Non-historic credits may not be taken for buildings separately listed on the National Register. Decertification was required both before and after TRA 86. Treas. Reg. § 1.48-12(c) (7) (iv). NOTE: Non-historic credits are not available for buildings which are residential rental. NOTE: Wall retention requirements apply to non-historic rehabs after TRA 86 and all rehabs prior to TRA 86.

Chapter 5	PLACED IN SERVICE **Applies both before and after TRA 86 <u>Applicable Law:</u> IRC § 47(b) Treas. Reg. § 1.48-12(f) (2) Treas. Reg. § 1.48-12(c) (6) Girgis Case	The rehab credit for qualified rehab expenditures is generally allowed in the taxable year in which the property is placed in service. NOTE: The concept of “Placed in Service” can relate to either the entire building or a portion of the building which is completed and available for rent or its respective income producing activity.
Chapter 6	SUBSTANTIAL REHABILITATION **Applies both before and after TRA 86 <u>Applicable Law:</u> IRC § 47(c) (1) Treas. Reg. § 1.48-12(b) (1) & (2) Alexander Case ** Also note section regarding multiple buildings (“Site”).	<u>In addition to receiving certification, projects must meet a substantial rehabilitation test in order to qualify for the credit.</u> The qualified rehabilitation expenditures during the 24 month period selected by the taxpayer must exceed the greater of $5,000 or the adjusted basis of the property determined at the beginning of such 24 month period. NOTE: Special 60 month rule (if phased rehab) must be part of architects plans, etc., IRC § 48(g) (1)(c) & Treas. Reg. 1.48-12(b) (1). NOTE: Congress’ intent was that a substantial amount of work was done and not just cosmetics. The test is intended to quantify “substantial”. This is one of the most confusing areas of Rehab Law.
Chapter 7	BASIS REDUCTION ** Applies both before and after TRA 86 but at different %’s. <u>Applicable Law:</u> Treas. Reg. § 1.48-12(e)	<u>Basis reduction required:</u> <u>After TRA 86:</u> The basis of the rehab expenditures must be reduced by 100% of the credit as taken. <u>Before TRA 86:</u> The basis of the rehab expenditures must be reduced by 50% of the credit as taken. For Non-historic projects, the basis reduction was increased to 100% for projects started after 1985.
Chapter 8	STRAIGHT LINE COST RECOVERY **Required both before and after TRA 86. <u>Applicable Law:</u> IRC § 47(c) (2) (B) (I) Treas. Reg. § 1.48-12(c) (7) (I) Au Case DeMarco Case Manning Case	<u>Straight Line Cost Recovery Required:</u> <u>Before TRA 86:</u> -Incurred after 12/31/81: 15 yrs. S/L -Incurred after 03/15/84: 18 yrs. S/L -Incurred after 05/08/85: 19 yrs S/L <u>After TRA 86: (MACRS-Methods)</u> -Incurred after 12/31/86 Residential - 27.5 Yrs. Non-Residential - 31.5 Yrs. -Incurred after 5/12/93: Residential = 27.5, Non-Residential = 39 Under the rehab provisions, there is a requirement that a straight-line method of depreciation be used.

Chapter 9	CREDIT RECAPTURE ** Required both before and after TRA 86 <u>Applicable Law:</u> IRC § 50 (a) Treas. Reg. § 1.48-12(f) (3) Rome Case *Prior to Rev Rec of 90 IRC § 47(a) contains similar provisions.	If there is a disposition or if the property ceases to be ITC property before the close of the recapture period of 5 years, there is a recapture of the credit amounting to 20% of the credit taken for each year less than 5 full years. NOTE: Although the credit is fully allowed in a given year, as long as the property had been placed in service by year end, the credit recapture is based on a "Full Year" concept. It is necessary to determine the actual date placed in service in order to compute the recapture.
Chapter 10	ACQUISITION COSTS EXCLUDED ** Both before and after TRA 86. <u>Applicable Law:</u> IRC § 47(c) (2)(B)(ii) Treas. Reg. § 1.48-12(c)(7)(ii) Treas. Reg. § 1/48-12(d) (9)	Acquisition costs are specifically excluded from the definition of qualified rehabilitation expenditures. The cost of acquiring any building or interest, therein; pre-rehab cost of acquiring the building or the cost of acquiring a rehabilitation building that had previously been placed in service would not qualify. Acquisition costs are still includible in the depreciable basis using the straight method. Also see issue regarding developer's fees and other costs which could potentially be recharacterized for their proper tax treatment.
Chapter 11	ENLARGEMENT EXPENDITURES AND DEMOLITION EXCLUDED ** Both before and after TRA 86. <u>Applicable Law:</u> IRC § 47 (c)(2)(B)(iii) Treas. Reg. § 1.48-12(c)(7)(iii) Treas. Reg. § 1.48-12(d)(10) IRC § 280B - Demolition	Enlargement costs of an existing building are specifically excluded from the definition of qualified rehabilitation expenditures. A building is enlarged to the extent that total volume is increased. Enlargement costs are still includible in the depreciable basis using the straight line method. Enlargement costs should be removed from the credit basis using a reasonable method of allocation. Demolition costs qualify as long as the building remains after the allowable demolition.
Chapter 12	SITEWORK EXPENDITURES EXCLUDED ** Applies both before and after TRA 86. <u>Applicable Law:</u> Treas. Reg. § 1.48-12(c) (5)	Sitework expenditures do not qualify for the credit and should be removed from the credit basis. Sitework includes any expenditures incurred for areas adjacent to or related to the rehabilitated building including sidewalks, paving, landscaping, parking lots, decks, remote site lighting, fencing, railings, ornamental fencing, gazebos, etc.
Chapter 13	SECTION 38/PERSONAL PROPERTY EXCLUDED ** Applies both before and after TRA 86 <u>Applicable Law:</u> IRC § 47(c) (2) (A) IRC § 38 ** See numerous court cases included in this section	Regular IRC § 38 Investment Credit property does not qualify for the rehab credit. Examples are office equipment, furniture, carpeting, drapes, kitchen appliances, cabinets, etc. NOTE: If disallowing or removing Section 38 property from the rehab basis then the straight line recovery election is no longer required for those items. Can allow ACRS, MACRS, etc. The Rehab Credit is only for the building and its structural components. There is sufficient law/cases under the ITC sections to support.

Chapter 14	TAX EXEMPT USE PROPERTY EXCLUDED Applicable Law: IRC § 47(c) (2) (B) (v) Treas. Reg. § 1.48-12(c) (7) (vi) IRC § 168 (h)	Tax exempt use property is specifically excluded from the definition of qualified rehabilitation expenditures. Any expenditures allocated to the portion of the property which is tax exempt use property must be removed from the credit basis. NOTE: There are special rules used to determine what is tax exempt use property
Chapter 15	LESSEE EXPENDITURES ** Applies both before and after TRA 86. IRC § 47(c) (2)(B)(ii) IRC § 168(c) Treas. Reg. § 1.48-12(c)(7)(v) Eubanks Case	Lessees are permitted to qualify their leasehold improvements incurred after 12/31/81 which otherwise qualify as rehab expenditures for the credit as long as the remaining term of the lease (without renewal periods) is less than the recovery period as defined in IRC § 168(c). (27.5 yrs for residential and 39 yrs for non-residential real property). NOTE: Lessees are also subject to the other issues previously mentioned.
Chapter 16	CONSTRUCTION PERIOD INTEREST AND TAXES ** Applies both before and after TRA 86. Applicable Law: IRC § 266 Treas. Reg. § 1.48-12(d)(9)	Election under IRC § 266 for construction period interest and taxes during the actual rehab qualifies for the credit. A statement of the election should be attached to the original return. Be sure to exclude any acquisition related interest from the rehab basis.
Chapter 17	PROGRESS EXPENDITURES Applicable Law: IRC § 47(d) Treas. Reg. § 1.48-12(f) (2) *Prior to Rev Rec of 90 IRC § 46(d) contains similar provisions	Usually, placed in service is the correct timing for taking the credit. An election can also be made to take credit corresponding to progress expenditures incurred during a tax year. It is still necessary to meet the requirements of the substantial rehabilitation test as previously mentioned. There are also special provisions of self-rehabilitated property
Chapter 18	FACADE EASEMENT REDUCTION OF BASIS Applicable Law: Rev. Rul. 89-90 Rev. Rul. 64-205 Treas. Reg. § 1.170A-13(h) (3)(iii) Rome Case Note: Disregard any Letter Rulings to the contrary	Reduction of basis of property retained should be adjusted by the part of the basis allocable to the easement granted. The method of determining the reduction of basis regarding the donation of the easement is to allocate the value of the easement to the shell, land and building and thus to reduce the basis of the rehab expenditures to the extent of disposition via the contribution. NOTE: If the building was rehabilitated and the credit taken prior to contribution of the facade easement then a recapture would be necessary based on the disposition and as calculated according to Section 50(a).

Chapter 19	DEVELOPER FEE/DEVELOPMENT COSTS ** Applies both before and after TRA 86. <u>Applicable Law:</u> ** See Phila. District Developers Fee Brief Carp/Zuckerman Case	Since the inception of the Rehabilitation Credit, "soft costs" such as architectural and engineering fees, consulting fees, site survey fees and "developer's fees" have always been allowable as part of the "Qualified Rehab Basis". As the term "developer's fees" has never been "quantified or qualified", this remains a "gray area" and has been discovered as a major area of abuse for these type cases. Issues addressed include nonallowable developer's profit included in a purchase price, disguised syndication fees, or amortizable costs, and non-arm's length transactions.
Chapter 20	PASSIVE ACTIVITY CREDIT RESTRICTIONS ** Applies after TRA 86. <u>Applicable Law:</u> IRC § 469 Treas. Reg. § 1.469-1T	If the activity of the project is rental or is a non-rental activity in which the owner/investor does not materially participate, the passive activity rules will set limits on the amount of credit that can be taken. Individuals can offset credit not exceeding $7,000 ($25,000 X 28% tax bracket) against their regular tax liability. The credit is phased out for individuals with income of $200,000 to $250,000.

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Form 4564 Rev. 6/88	Department of the Treasury Internal Revenue Service **INFORMATION DOCUMENT REQUEST**	Request Number
TO: Name of Taxpayer and Co. Div. or Branch Please return Part 2 with listed documents to requester identified below.		Subject SAIN No. | Submitted to: Dates of Previous Requests

Description of Documents Requested

Please present the following documents and information regarding the partnership examination for tax year(s) ____________________________.

1. A copy of the Prospectus/Offering Memorandum relating to the above partnership activity.

2. Certification of rehabilitation expenses by The Department of The Interior (Parts I, II, and III) if applicable.

   a. Exact address or location of the building.

   b. Does the above partnership own the entire rehabilitated structure. If not, please provide a statement indicating what portion of the building the partnership owns.

   ____%; ____units of a total of____units; ____floors of a total of ____floors; etc.

Information Due By___________ At Next Appointment [ ] Mail In [ ]		
FROM:	Name and Title of Requester	Date
	Office Location	

Form 4564 Rev. 6/88	Department of the Treasury Internal Revenue Service **INFORMATION DOCUMENT REQUEST**	Request Number
TO: Name of Taxpayer and Co. Div. or Branch Please return Part 2 with listed documents to requester identified below.		Subject SAIN No. | Submitted to: Dates of Previous Requests

Description of Documents Requested

3. If the building is not a certified rehabilitation, then please provide the following information:

   a. Exact address or location of the building.

   b. Does the above partnership own the entire rehabilitated structure. If not, please provide a statement indicating what portion of the building the partnership owns.

   ____%;____units of a total of ____units; ____floors of a total of ____floors; etc.

4. Settlement sheets for the acquisition of any properties relating to the form 1065 filed.

5. Certificate and/or Statement of Occupancy.

6. Copy of the first lease executed.

7. If a facade easement is involved, please provide the Deed and Appraisal of the facade easement.

8. A copy of the partnership form 1065 for tax year(s)_________________.

9. Workpapers used in preparing the return.

10. Copies of any Partnership Agreements executed.

Information Due By__________ At Next Appointment [ ] Mail In [ ]		
FROM:	Name and Title of Requester	Date
	Office Location	

Form 4564 Rev. 6/88	Department of the Treasury Internal Revenue Service INFORMATION DOCUMENT REQUEST	Request Number
TO: Name of Taxpayer and Co. Div. or Branch Please return Part 2 with listed documents to requester identified below.		Subject SAIN No. | Submitted to: Dates of Previous Requests

Description of Documents Requested

11. All bank statements and canceled checks for the Partnership.

12. Financing Agreements/Mortgages for all properties.

13. Construction contract including a specific breakdown of rehabilitation costs and any construction loan agreements.

14. Ledger Account/AIA statements for the construction mortgage showing draws for work performed.

15. Identification of the partnership's 24 or 60 month measuring period for purposes of the substantial rehabilitation provisions.

16. Documentation/Records pertaining to the capital contributions made by all of the partners, including all notes.

17. Records of all loans and repayments.

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Note: The above IDR should be modified for different types of owners including Corporations and Individuals, and should also be expanded to address any other issues that the examiner determines to warrant review. Some of the items should be deleted if not applicable, for example, the question regarding the Facade could be deleted if no Facade Contribution was taken by the taxpayer under audit. Also for example, if you were examining a corporate taxpayer then the Corporate Minutes might be requested instead of a Partnership Offering Memorandum.
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Information Due By__________ At Next Appointment [ ] Mail In [ ]		
FROM:	Name and Title of Requester	Date
	Office Location	

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Chapter 2

CERTIFICATION PROCESS

The rehabilitation of a certified historic structure must meet the Department of the Interior's standards for rehabilitation to qualify rehabilitation expenditures for the rehabilitation credit. A building or site is considered certified if it is separately listed on the National Register of Historic Places. If the building or site is not separately listed, the owner can apply to the Department of the Interior's National Park Service for an Evaluation of Significance. This is done by filing Historic Preservation Certification Application Part I – Evaluation of Significance (Form 10–168). This certification is not needed for the non-historic credit.

Part 1 is used in the following instances:

1. To request certification that a building contributes to the significance of a registered historic district.

2. To request certification that a building or structure, and where appropriate, the land area on which such building or structure is located contributes to the significance of a registered historic district for charitable contribution for conservation purposes.

3. To request certification that the building does not contribute to the significance of a registered historic district (needed to claim the non-historic rehabilitation credit, see Chapter 4, Non-Historic Credits).

4. To request a preliminary determination for individual listing in the National Register of Historic Places.

5. To request a preliminary determination that a building located within a potential historic district contributes to the significance of the district.

6. To request a preliminary determination that a building outside the period or area of significance contributes to the significance of the district.

The application must include a description of the physical appearance of each building, including all major features of the building and a statement of significance with photographs and maps. All applications for preliminary determinations must contain all documentation showing that the building, or the district where the building is located, meets the National Register Criteria for Evaluation.

A determination of the rehabilitation of the certified historic structure is requested by filing Part II – Description of Evaluation (Form 10–168a). This form should be completed and submitted prior to the initiation of any rehabilitation work. Proposed work which does not appear to be consistent with the Department of the Interior's standards will be identified. The owner will also be advised how to bring the project into conformance with the Standards for Rehabilitation. The application should include a detailed description of all the rehabilitation work, including all sitework, exterior and interior work, and new construction. Each key feature before the rehabilitation is identified, its physical condition described and the proposed rehabilitation explained. The application should also include "before" photographs, drawing or sketches, and any other special rehabilitation concerns. Examples of special concerns may include storefront alterations; new heating, ventilation, or air conditioning systems; windows; and masonry restoration.

Once the rehabilitation work is completed, the owner must then submit a Request for Certification of Completed Work (Form 10–168c). This form is often referred to a Part III. Part III must include a description and photographs of the completed work as described for the proposed rehabilitation. In addition, the names and taxpayer identification numbers of all the owners must be provided. The overall project does not become a certified rehabilitation until the Part III is completed and approved by the National Park Service, and the building is designated a "Certified Historic Structure."

All documented applications will be reviewed within 60 days of receipt (30 days at the state level and 30 days at the federal level). The State Historic Preservation Office will issue a notification regarding recommendations made to the National Park Service. The National Park Service will then issue a notification as to the certification of the overall project. Copies of which are provided to the State Historic Preservation Office and the Internal Revenue Service. A nonrefundable processing fee is charged for review of requests for certification of rehabilitation work. Final action on an application is not taken until payment is received.

In addition to the above certifications, two other elements must exist for an owner to claim the credit. The building must be placed in service and a substantial rehabilitation test must be met. The final certification of both the structure and the rehabilitation work is not necessary at the time the credit is taken. However, the certification must ultimately be obtained by the building owners/taxpayers.

The certification of the structure and the rehabilitation work should be filed with the return on which the credit was taken (Tax Form 3468 Investment Tax Credit). If the final certification has not been obtained, then Parts I and II (as filed with the State Historic Preservation Office) should be attached to Form 3468 indicating that it was received by the National Park Service or the applicable State Historic Preservation Office.

There are additional requirements (30-Month Rule) if a taxpayer does not obtain certification within 30 months of filing the tax return on which the Rehabilitation Tax Credit is claimed. (Refer to Chapter 3, Certification Requirements, for detailed explanation.) Exhibit 2–1 is a listing of the National Park Service Regional Offices. Exhibit 2–2 is a listing of the State Historic Preservation Offices.

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<u>Exhibit 2–1</u>

NATIONAL PARK SERVICE REGIONAL OFFICES ISSUING CERTIFICATIONS

REGIONAL OFFICE	STATES WITHIN REGION
Alaska Region Preservation Tax Incentives National Park Service 2525 Gambell Street Anchorage, Alaska 99503 (907) 257–2543	Alaska
Mid-Atlantic Region Preservation Tax Incentives National Park Service Office of Cultural Programs U.S. Custom House 2nd Floor Second and Chestnut Streets Philadelphia, PA 19106 (215) 597–1577	Connecticut, Delaware, District of Columbia, Indiana, Maine, Maryland, Massachusetts, Michigan, New Hampshire, New Jersey, New York, Ohio, Pennsylvania, Rhode Island, Vermont, Virginia, West Virginia
Rocky Mountain Region Preservation Tax Incentives National Park Service 12795 W. Alameda Parkway P.O. Box 25287 Denver, Colorado 80225 (303) 969–2875	Colorado, Illinois, Iowa, Kansas, Minnesota, Missouri, Montana, Nebraska, New Mexico, North Dakota, Oklahoma, South Dakota, Texas, Utah, Wisconsin, Wyoming
Southeast Region Preservation Tax Incentives National Park Service 75 Spring Street, SW Atlanta, Georgia, 30303 (404) 331–2632	Alabama, Arkansas, Florida, Georgia, Kentucky, Louisiana, Mississippi, North Carolina, Puerto Rico, South Carolina, Tennessee, Virgin Islands
Western Region Preservation Tax Incentives National Park Service 600 Harrison Street Suite 600 San Francisco, California 94107–1372 (415) 744–3988	Arizona, California, Hawaii, Idaho, Nevada, Oregon, Washington

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STATE HISTORIC PRESERVATION OFFICES

Alabama:	Executive Director, Alabama Historical Commission 725 Monroe Street Montgomery, AL 36130 (205) 242–3184
Alaska:	Office History and Archaeology Division of Parks and Outdoor Recreation P.O. Box 7001 Anchorage, AK 99510 (907) 762–4137
Arizona:	State Historic Preservation Officer Arizona State Parks 800 West Washington Street Suite 415 Phoenix, AZ 85007 (602) 542–4009
Arkansas:	Director, Arkansas Historic Preservation Program Suite 1500 Tower Building 323 Center Street Little Rock, AR 72201 (501) 324–9150
California:	State Historic Preservation Officer Office of Historic Preservation Department of Parks and Recreation P.O. Box 942896 Sacramento, CA 94296–0001 (916) 653–9134
Colorado:	President, Colorado State Historical Society Colorado State Museum 1300 Broadway Denver, CO 80203 (303) 866–3355
Connecticut:	Director, Connecticut Historical Commission 59 South Prospect Street Hartford, CT 06106 (203) 566–3005
Delaware:	Director, Division of Historical and Cultural Affairs Hall of Records Dover, DE 19901 (302) 739–5313

District of Columbia:	Division Chief, Historic Preservation Division 614 H Street, N.W., Suite 305 Washington, DC 20001 (202) 727–7360
Florida:	Director, Division of Archives History and Records Management Department of State 500 Bronough Street Tallahassee, FL 32399–0250 (904) 488–1480
Georgia:	Chief, Historic Preservation Section 1462 Floyd Towers East 205 Butler Street, SE Atlanta, GA 30334 (404) 656–2840
Hawaii:	Chairperson, Department of Land and Natural Resources 33 South Sing Street Honolulu, HI 96813 (808) 587–0047
Idaho:	Director, Idaho Historical Society 210 Main Street Boise, ID 83702 (208) 334–3861
Illinois:	Associate Director, Illinois Historic Preservation Agency Preservation Service Division Old State Capital Springfield, IL 62701 (217) 785–4512
Indiana:	Director, Department of Natural Resources 402 West Washington Street Indiana Government Center South, Room C-256 Indianapolis, IN 46204 (317) 232–4020
Iowa:	Administrator, State Historical Society of Iowa Bureau of Historic Preservation Capitol Complex Des Moines, IA 50319 (515) 281–8719
Kansas:	Executive Director, Kansas State Historical Society 120 West 10th Street Topeka, KS 66612 (913) 296–3251

Kentucky:	Director, Kentucky Heritage Council 300 Washington Street Frankfort, KY 40601 (502) 564–7005
Louisiana:	Assistant Secretary, Office of Cultural Development P.O. Box 44247 Baton Rouge, LA 70804 (504) 342–8200
Maine:	Director, Maine Historic Preservation Commission 55 Capitol, Station 65 Augusta, ME 04333 (207) 289–2132
Maryland:	Director of Historical and Cultural Programs Department of Housing and Community Development 100 Community Place, Third Floor Crownville, MD 21032 (301) 514–7600
Massachusetts:	Executive Director, Massachusetts Historical Commission 80 Boylston Street, Suite 310 Boston, MA 02116 (617) 727–8470
Michigan:	Director, Bureau of History, Department of State 717 West Allegan Street Lansing, MI 48918 (517) 373–0511
Minnesota:	Director, Minnesota Historical Society State Historic Preservation Office 245 Kellogg Blvd West St. Paul, MN 55102 (612) 296–2479
Mississippi:	Director, State of Mississippi Department of Archives and History P.O. Box 571 Jackson, MS 39205 (601) 359–6940
Missouri:	Director, Department of Natural Resources P.O. Box 176 Jefferson City, MO 65101 (314) 751–2479
Montana:	Program Manager, Montana Historical Society Historic Preservation Office 225 North Roberts Street Helena, MT 59620 (406) 444–7715

Nebraska:	Director, Nebraska State Historical Society P.O. Box 82554 Lincoln, NE 68501 (402) 471–3270
Nevada:	Supervisor, Department of Conservation and Natural Resources 123 West Nye Lane, Room 208 Capital Complex Carson City, NV 89710 (702) 687–5138
New Hampshire:	Director,Division of Historical Resources and State Historic Preservation Office P.O. Box 2043 Concord, NH 03301 (603) 271–3483
New Jersey:	Commissioner, Department of Environmental Protection CN-402 401 East State Street Trenton, NJ 08625 (609) 292–2885
New Mexico:	Director, Historic Preservation Division Office of Cultural Affairs Villa Rivera, Room 101 228 East Palace Avenue Santa Fe, NM 87503 (505) 827–6320
New York:	Commissioner, Parks, Recreation and Historic Preservation Agency Building #1, 20th Floor Empire State Plaza Albany, NY 12238 (518) 474–0443
North Carolina:	Director, Division of Archives and History Department of Cultural Resources 109 East Jones Street Raleigh, NC 27611 (919) 733–4763
North Dakota:	Superintendent, State Historical Society of North Dakota North Dakota Heritage Center Bismarck, ND 58505 (701) 224–2672
Ohio:	State Historic Preservation Officer The Ohio Historical Society, Historic Preservation Division 1982 Velma Avenue Columbus, OH 43211 (614) 297–2470

Oklahoma:	Director, Oklahoma Historical Society, State Historic Preservation Office 621 N. Robinson Street Oklahoma City, OK 73105 (405) 521–6249
Oregon:	Director, State Parks & Recreations Department 525 Trade Street, SE Salem, OR 97310 (503) 378–5001
Pennsylvania:	Executive Director, Pennsylvania Historical and Museum Commission P.O. Box 1026 Harrisburg, PA 17108 (717) 787–2891
Commonwealth of Puerto Rico:	State Historic Preservation Officer Office of Historic Preservation Box 82, La Fortaleza San Juan, PR 00901 (809) 721–3012
Rhode Island:	State Historic Preservation Officer Rhode Island Historical Preservation Commission Old State House 150 Benefit Street Providence, RI 02903 (401) 277–2678
South Carolina:	Director, Department of Archives and History Box 11669, Capitol Station Columbia, SC 29211 (803) 734–8592
South Dakota:	Director, State Historical Preservation Center P.O. Box 417 Vermillion, SD 57069 (605) 677–5314
Tennessee:	Commissioner, Department of Conservation 701 Broadway Nashville, TN 37203 (615) 742–6724
Texas:	Executive Director, Texas Historical Commission P.O. Box 12276 Capitol Station Austin, TX 78711 (512) 463–6094
Utah:	Director, Utah State Historical Society 300 Rio Grande Salt Lake City, UT 84101 (801) 533–3500

Vermont:	Agency Counsel, Agency of Development and Community Affairs 109 State Street Montpelier, VT 05609 (802) 828–3211
Virginia:	Director, Department of Historic Resources Commonwealth of Virginia 221 Governor Street Richmond, VA 23219 (804) 786–3143
Virgin Islands:	Commissioner, Department of Planning and Natural Resources Suite 231, Nisky Center No. 45A Estate Nisky St. Thomas, USVI 00802 (809) 774–3320
Washington:	Director, Office of Archeology and Historic Preservation 111 21st Avenue Southwest P.O. Box 48343 Olympia, WA 98504 (206) 753–4117
West Virginia:	Commissioner, Department of Culture and History Capitol Complex Charleston, WV 25305 (304) 348–0220
Wisconsin:	Director, Division of Historic Preservation State Historical Society of Wisconsin 816 State Street Madison, WI 53706 (608) 264–6515
Wyoming:	Director, Parks and Cultural Resources Division Department of Commerce, Barrett Building 2301 Central Avenue Cheyenne, WY 82002 (307) 777–7697

Chapter 3

CERTIFICATION REQUIREMENTS

BACKGROUND

To obtain the 20 percent Certified Historic Rehabilitation Credit the property must be either listed on the National Register of Historic Places or located in a Registered Historical District and be determined "significant" to that district. Additionally, the Secretary of the Interior must certify to the Secretary of the Treasury that the project meets their "standards" and is a "Certified Rehabilitation." This certification is obtained by the owner filing the three part application with the National Park Service.

To have a rehabilitation project's work certified by the National Park Service, there are a series of applications which are filed with the appropriate State Historic Preservation Office. These applications are reviewed and are then forwarded with recommendations to the National Park Service for approval or denial. The applications include:

Part I – Evaluation of Significance – This part usually contains a narrative which describes the history of the particular building and is an attempt to convince the National Park Service that the building is "significant" to the historical district within which it is located.

Part II – Description of Rehabilitation – This part is intended to provide both the state, and the National Park Service with a narrative, pictures which outline the particular architectural and historical features of the building as they currently exist, and a description of the proposed work to be undertaken.

Note: It is usually recommended that both Part I and II be filed before any work is started on the project.

Part III - Request for Certification of Completed Work – This final part of the application process is intended to be filed by the owners to notify both the state, and the National Park Service, that the project is completed and that the owners are requesting that the project be reviewed to receive certification. This part includes pictures of the completed rehabilitation. In some cases the building can be subject to an on-site visit by the state or the National Park Service.

When examining a return exhibiting the Historic Rehabilitation Credit it is necessary (at a minimum), to verify that the project has (1) received "certification" of the work, and (2) that the building was deemed a "Certified Historic Structure" by virtue of either (a) being separately listed in the National Register of Historic Places, or (b) by its location in a registered historic district and the determination that it "contributes to the significance" of that district.

This certification of both the structure and the rehabilitation work is not necessary at the time that the credit is taken. Ultimately, however, the certification must be obtained by the building owners/taxpayers. Under Treas. Reg. section 1.48–12(d)(7)(i) and (ii), it is indicated that the certification should be filed with the return on which the credit was taken. If the final certification has not been obtained, then at a minimum, the Part 2, as filed with the State Historic Preservation Office, should be attached to the return with an indication that it was either received by the National Park Service, or the applicable State Historic Preservation Office.

Treas. Reg. section 1.48–12(f)(2), states that the credit may be claimed if the property is placed in service, and the substantial rehabilitation test has been met. The pro forma Information Document Request (Form 4564) addresses this issue based on the request of items number 2, 5, 6, and 15. Treas. Reg. section 1.48–12(d)(7)(ii) lists the steps prescribed for dealing with late certifications. Included with this section is a "30 Month Rule" which indicates that if the taxpayer fails to receive final certification of completed work prior to the date that is 30 months after the date that the taxpayer filed the tax return on which the credit was claimed, the taxpayer <u>must submit a written statement to the district director stating such fact prior to the last day of the 30th month, and the taxpayer should be requested to consent to an agreement under IRC section 6501(c)(4) extending the period of assessment for any tax relating to the time for which the credit was claimed.</u>

Based on the above, and legal arguments including the "Doctrine of Equitable Estoppel," the Examination Division of the Philadelphia District in conjunction with both their District Counsel, and National Office Counsel, has developed a position for dealing with cases where the normal 3 year statute of limitations is barred. This position has been applied to cases where the proper certification was never obtained, and where the 30 month rule as cited above was ignored. These cases can be completely developed based on documentation from the National Park Service.

If the final certification was not obtained, and an examiner has a case either within statute, or where the statute is barred, that taxpayer/owner should be notified, and afforded one last opportunity to obtain the proper certification from the National Park Service. If the certification is denied, and all avenues of attaining the certification have been exhausted, then the credit should be disallowed in the year taken. Note: Lack of certification does not constitute a credit <u>recapture</u> under IRC section 50(a), or previously under IRC section 47(a), but in fact should be disallowed in the year taken based on the law sections which follow.

Also note that the estoppel position can only be used in cases where IRS becomes aware of the lack of certification after the normal 3 year statute has expired. If you are examining a tax return which exhibits a historic credit, and you have determined that the subject building lacks the necessary certification, you should ensure that the statute is protected until the final certification is obtained, or the credit has been properly disallowed. If an examiner discovers that they have a case lacking certification where the statute is barred, and the estoppel position may be applied, they should contact Philadelphia District.

CERTIFICATION LAW SECTIONS

Rehabilitation Credit/Amount of Credit - See IRC Section 47(a)

When the credit may be claimed. See IRC Section 47(b)

When the credit may be claimed/if placed in service and substantial rehabilitation test has been met. See Treas. Reg. section 1.48-12(f)(2)

RULES APPLICABLE TO REHABILITATIONS OF CERTIFIED HISTORIC STRUCTURES CERTIFICATION REQUIREMENTS

Certain expenditures are not included. See IRC Section 47(c)(2)(B)(iv), IRC Section 47(c)(2)(C) and 47(c)(3), and Treas. Reg. Section 1.48-12(d).

CERTIFICATION REQUIREMENTS AND RULES FOR CERTIFIED HISTORIC STRUCTURES

Notice of Certification Required With Return. See Treas. Reg. section 1.48-12(d)(7)(i)

Late Certification and 30-Month Rule - See Treas. Reg. section 1.48-12(d)(7)(ii)

Definition of Registered Historic District - See Treas. Reg. section 1.48-12(d)

Non-certified rehabilitations are not allowable for certified, historic structures (building separately listed on the National Register of Historic Places) or for buildings located in a registered historic district (buildings determined to be "Significant to the District").

COURT CASES

In *Girgis V. Commissioner,* T.C. Memo 1991–191, a decision was entered that in order for an expenditure in connection with the rehabilitation of a "Certified Historic Structure" to be a "Qualified Rehabilitation Expenditure," the rehabilitation must be a "Certified Rehabilitation" as defined under IRC section 48(g)(2)(B)(iv) (or under current law 47(c)(2)(B)(iv)). It goes on further to define a "Certified Rehabilitation" as "any rehabilitation of a certified historic structure which the Secretary of the Interior has certified to the Secretary (of the Treasury) as being consistent with the historical character of such property or the district in which such property is located," IRC section 48(g)(2)(C) (or under current law 47(c)(2)(C)). It was also held that if a building is deemed to be a "Certified Historic Structure", that building will only qualify for the historic rehabilitation credit and does not qualify for the non-historic credit for older buildings. The courts cited IRC sections 48(g)(1) (or under current law, 47(a)(1)) and 46(b)(4)(C)(ii)).

In *B. G. Anderson*, 62 TCM 1324, Dec. 47,769(M), T.C.Memo, 1991–583, no rehabilitation tax credit was allowed based on the mere listing of a building on the National and Philadelphia Register of Historic Places.

In *Booker T. Washington Broadcasting Services Inc. v. United States*, 92–2 U.S.T.C. 50,545, a taxpayer was not entitled to the certified rehabilitation tax credit because taxpayer failed to apply for certification until nearly 3 years after taxpayer claimed the credit.

In *J. Franklin Dennis and Beverly A. Dennis v. Commissioner*, T.C. Memo 1993–345, a property owner was denied the rehabilitation tax credit because the owner used the property solely as his personal residence. Further, he had not received a certification of the rehabilitation from the Secretary of the Interior. Furthermore, there was no evidence that the owner followed the "30 month rule."

In *Schneider Partnership*, DC N.J., 89–1 U.S.T.C. 99319, no rehabilitation tax credit was allowed where the certification was denied by the Secretary of the Interior.

Chapter 4

NON-HISTORIC CREDITS

BACKGROUND

As previously discussed in Chapter 1, Legislative History Section, Congress determined that due to the popularity of the Historic Rehabilitation Credit, incentives for rehabilitating older non-historic buildings could probably achieve the same success. In 1981, the Economic Recovery Tax Act introduced an additional two tiers of non-historic rehabilitation credits, including a 20 percent credit for buildings that were at least 40 years old, and a 15 percent credit for buildings that were at least 30 years old. Based on the changes brought about by the Tax Reform Act of 1986, the credit amount for non-historic rehabilitation was changed to 10 percent, and an additional provision was introduced which required that the building had been originally placed in service before 1936.

To obtain the 10 percent Non-Historic Rehabilitation Credit, the property must meet certain criteria. Then on-historic building must be used for non-residential purposes. Non-residential use includes commercial, office, or any other type of use not considered to be residential rental use. Note, under IRC section 48(a)(3)(D) for the historic credit only, the law specifically allows that the property can be residential rental use property.

Buildings which are certified historic structures are precluded from taking any credits other than the historic rehabilitation credit. Thus, the historical rehabilitation application procedures as outlined in Chapter 2, Certification Requirements, must be followed, and the only credit allowed would be the certified historic rehabilitation credit. Non-historic credits would generally not be allowed for historic buildings with one exception. If a building is located within a historic district, but is generally of a different age than the time frame as reflected in that district, or for any other reason the building does not contribute to, or is not characteristic of the historical integrity of that district, the owner may apply to the National Park Service for "decertification." Using the "Part 1" application, the owner submits a narrative to the State Historic Preservation Office (and ultimately the National Park Service) to demonstrate that the building, although physically located within the district, does not contribute to the significance of the district. NOTE: this "decertification" is the only way that the building owner would be entitled to take the non-historic credit (assuming all other law provisions are followed). If a case exhibiting a non-historic credit is encountered, the examiner should ensure that the property is not separately listed, is not located within a historic district, or, if it is located within a historic district, that the proper "decertification" was obtained in order to qualify for the non-historic credit. As with the historic credits, if an examiner encounters a case where a non-historic credit has been taken for property located within a historic district, then the examiner should afford the building owner the necessary time to obtain the "decertification." If the "decertification" cannot be obtained, then the non-historic credit should be disallowed in full, unless the owner can attain historic certification which would then qualify the building for the historic rehabilitation credit. NOTE: the State Historic Preservation Offices can usually provide detailed maps of registered historic districts within the state.

In addition to the requirements as mentioned above, there is also an additional requirement regarding wall retention for the non-certified rehabilitations. This requirement is:

1. 50 percent or more of the existing external walls of such building are retained in place as external walls

2. 75 percent or more of the existing external walls of such building are retained in place as internal or external walls

3. 75 percent or more of the existing internal structural framework of such building is retained in place.

The wall retention requirements previously existed for both the historic and the non-historic credits prior to the Tax Reform Act of 1986, but were dropped for the historic credits based on the practical implications. For certified projects, destruction of walls, whether internal or external, must be approved by the National Park Service, and is usually discouraged. The Code and regulations that follow address the definitions and various technicalities of this section.

The pro forma Information Document Request (see Exhibit 1–2) addresses the non-historic credit issue through the request of Item 3. The certification of the work is not required for non-historic buildings as long as they are not considered "Certified Historic Structures." It should also be noted that besides meeting the "use", "age" and "wall retention" requirements, it is also necessary to fulfill the other law requirements such as the substantial rehabilitation test, use of straight line depreciation, etc. The law sections which follow address specific provisions of the law which pertain to non-historic rehabilitation credits.

<u>NON-HISTORIC CREDITS LAW</u>

Rehabilitation Credit/Amount of Credit - See IRC Section 47(a).

The prohibition of residential rental property for purposes of the credit exists for non-historic credits but not those which qualify for the certified historic credit. See Treas. Reg. Section 1.48-1(h)(1)(i) and (h)(2)(iv).

For rules applicable to rehabilitations of certified historic structures/certification requirements refer to Treas. Reg. 1-48-12(d).

Treas. Reg. section 1.48–12(d) provides the definition of a Registered Historic District.

Non-certified rehabilitations are not allowable for certified historic structures (buildings separately listed on the national register of historic places) or for buildings located in a registered historic district (buildings determined to be "significant" to the district).

Definitions/Qualified Rehabilitated Building are found in IRC Section 47(c).

For the provisions regarding non-certified rehabilitations, see IRC Section 47(c)(1)(B).

Age Requirement/Non-certified rehabilitations. See Treas Reg. 1.48-12(b)(4).

Effects of additions after 1936 and effects of vacant periods for non-certified rehabilitations. See Treas. Reg, 1.48-12(b)(4)(ii) and (iii).

NON-CERTIFIED REHABILITATIONS MUST BE AT THE LOCATION WHERE THE BUILDING HAS BEEN LOCATED SINCE BEFORE 1936

Location of rehabilitation for non-certified rehabilitations. See Treas. Reg. Section 1.48-12(b)(5).

DEFINITION AND SPECIAL RULES FOR "PHYSICAL WORK ON A REHABILITATION" AND ADJOINING BUILDINGS WHICH WERE COMBINED

Physical work defined and rules for adjoining buildings. See Treas. Reg. 1.48-12(b)(6)(i) and (iii).

WALL RETENTION REQUIREMENTS FOR NON-CERTIFIED REHABS

Retention of existing external walls and framework. See IRC Section 47(c)(1)(A) and Treas. Reg. 1.48-12(b)(3)((i).

Retention of Walls – Transition Rule. See Treas. Reg. Section 1.48-12(b)(3)(i)(C) and (D)

Definition of external wall - Treas. Reg. section 1.48–12(b)(3)(ii).

Definition – Internal Structural Framework. See Treas. Reg. section 1.48–12(b)(3)(iii).

Definition – Retained In Place. See Treas. Reg. section 1.48–12(b)(3)(iv).

Effects of additions. See Treas. Reg. section 1.48–12(b)(3)(v).

See Treas. Reg. section 1.48–12(b)(3)(vi) for examples of wall retention requirements.

COURT CASES

In *Girgis V. Commissioner*, T.C. Memo 1991–191, a decision was entered that if a building is deemed to be a "Certified Historic Structure," that building will only qualify for the historic rehabilitation credit, and does not qualify for the non-historic credit for a 40-year old building. The courts cited IRC sections 48(g)(1) (or under current law, IRC section 47(a)(1)), and 46(b)(4)(C)(ii).

In *Nalle v. Commissioner,* 99 T.C. No. 9, a decision was entered that no rehabilitation credit is allowed with respect to a building which was relocated prior to its rehabilitation.

J. Bailey, 88 T.C. 1293, Dec. 43,924, no rehabilitation credit was allowed for improvements to a building which was used as residential property, and the structure was not a certified historic structure.

In *Depot Investors LTD*, 63 TCM 2344, Dec. 48,065(M), T.C. Memo 1992–145, no rehabilitation credit was allowed for a building because the wall retention requirements were not met.

Chapter 5

PLACED IN SERVICE

BACKGROUND

The actual timing for the owners to take the credit is when the building is placed in service. If the owners of the project have completed rehabilitation and are only waiting for the final certification of completed work from the National Park Service, they should take the credit for that year if the substantial rehabilitation test is met (see Chapter 6, Substantial Rehabilitation Test). If the building is large, and is placed in service in identifiable parts, (floors, etc.), the credit may be taken on those parts as long as the substantial rehabilitation test has been met at that point in time.

"Placed in service" generally means that the appropriate work has been completed which would allow occupancy of either the entire building, or some identifiable portion of the building. The taxpayer/owner cannot have just incurred expenditures related to various parts of the building, and include them in a rehabilitation basis unless the related building or part of the building is available to be placed in service. A "Certificate of Occupancy" is one means of verifying the "Placed in Service" date for the entire building (or part thereof).

The Information Document Request (IDR) (see Exhibit 1–2) addresses this issue through Items 4, 5, 6, and 14. The best approach to this issue is not to rely on one single item of verification, but to look at all of the various items and how they relate to each other. All of the items should be consistent in reflecting that either all or part of the building was available to be placed in service as of the particular date that the taxpayer/owner purported to have placed the building in service per the return. This approach provides cohesive evidence to accept the "placed in service" date if all are consistent.

If a taxpayer purchases a building or property where rehabilitation expenditures have already been incurred, that taxpayer may take the credit so long as the building or property has not been placed in service, and a credit has not been taken by the previous owner. This particular scenario could be present in a condominium situation, a failed project which is completed and eventually placed in service by a subsequent owner, or a project where the developer from the outset has the intention of rehabilitating a structure and then selling the completed project.

In all of these situations, the important factor is whether or not the building (or part of the building or condominium) has been placed in service. If previously placed in service, and a subsequent sale or disposition takes place, then credit recapture would be necessary for the original owner. (See Chapter 9, Credit Recapture on

Disposition.) Also note that if the property is sold to a new owner, and the previous owner recaptured the credit due to the disposition of the property, the new purchaser/owner of the property is not entitled to any credit. The only one ever entitled to the credit is the first owner to place the building, (or a portion thereof) in service. If the property is first used for a personal use and then later converted to an income producing activity, rental real estate, etc., no credit is allowed upon a conversion.

PLACED IN SERVICE LAW

When The Credit May Be Claimed - See IRC section 47(b) and Treas. Reg. section 1.48–12(f)(2)

When Expenditures May be Incurred/When are Expenditures Considered Qualified Rehabilitation Expenditures. See Treas. Reg. Section 1.48–12(c)(6)

Definition of Qualified Rehabilitation. See Treas. Reg. Section 1.48–12(c)(3)

COURT CASE

In *Girgis V. Commissioner*, T.C. Memo 1991–191, a decision was entered that the petitioner does not qualify for the rehabilitation credit because the prior owner had already placed the building in service and had already claimed credits based on the rehabilitation expenditures made in connection with the said building. The courts cited Treas. Reg. section 1.48–12(c)(3)(ii).

Chapter 6

SUBSTANTIAL REHABILITATION

BACKGROUND

Aside from Congress' primary intent that incentives be created to rehabilitate older and historical buildings, they also wanted the buildings to be "substantially rehabilitated." After coining the terminology, the next task was to define "substantial rehabilitation." The following section discusses the prescribed substantial rehabilitation test, as included in both the Code and regulations, and its various practical implications.

The qualified rehabilitation expenditures during a 24-month period selected by the owners must exceed the greater of $5,000 or the adjusted basis of the property. NOTE: This is only a test and once met, expenditures before and after the 2-year period generally will qualify for inclusion in the Rehabilitation Tax Credit basis. Long-term projects may use an alternative 60-month period of the long-term nature of the project is evident from the outset, (architectural plans, etc.). This section of the law can be confusing; the key fact to remember is that it was designed only as a test to ensure that something more than cosmetic repairs are performed on the building. It was not intended to limit the owners to a strict 2-year period during which all work must be started and concluded.

THE SUBSTANTIAL REHABILITATION TEST

IRC section 47(c)(1)(C) defines substantially rehabilitated.

Treas. Reg. section 1.48–12(b)(2)(i) defines "substantial rehabilitation." The regulations also state that if a building is owned by a partnership or an S-Corporation, then the Substantial Rehabilitation Test shall be determined at the entity level. Examples of the application of the Substantial Rehabilitation Test are as follow.

Example 1

- "A" purchases the building on January 1, 1990 for $140,000.
- Rehabilitation costs incurred in 1990 were $4,000 per month for a total of $48,000 for the year 1990.
- 1991 year rehabilitation costs were $100,000 for the year.

– 1992 year rehabilitation costs were $2,000 a month for 10 months through October 31, 1992, for a total of $20,000 for 1992.

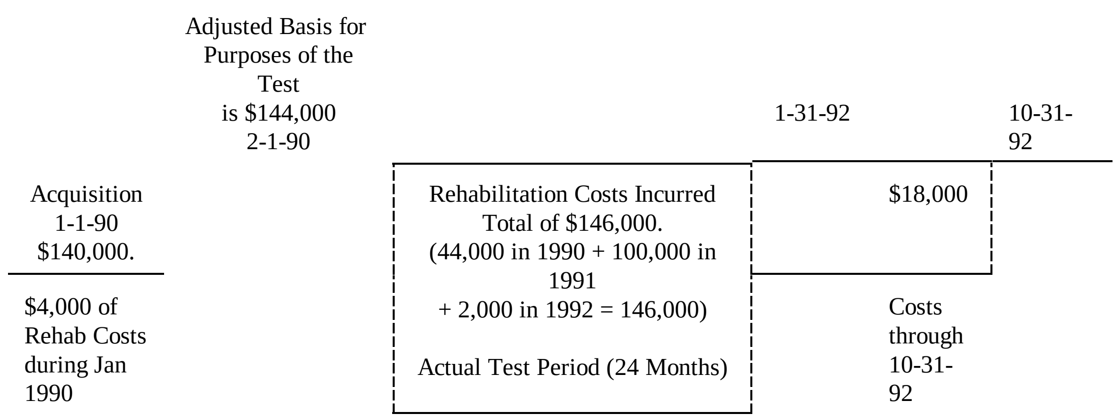
– There were no long-term architectural plans for the project; therefore, "A" is limited to a "24 month" Substantial Rehabilitation Test period.

– "A" selects the measuring period beginning on February 1, 1990 and ending on January 31, 1992 (24 months).

– The beginning adjusted basis (for purposes of the test only), and based on the 24– month test start date, is calculated as follows:

  Purchase price of $140,000 + $4,000 of rehabilitation costs incurred through January 31, 1990 equals $144,000.

Actual Test for Example 1:



NOTE: In the example above, the test was met as the beginning adjusted basis was $144,000 while the rehabilitation costs incurred during the 24-month period from February 1, 1990, through January 31, 1992, were $146,000, and exceeded the adjusted basis of the building. Since the test is now met, the actual costs which qualify are as follows:

– The $4,000 of rehabilitation costs incurred before the test period (from January 1, 1990, through January 1, 1990).

– The $146,000 of rehabilitation costs incurred during the test period from February 1, 1990, through January 31, 1992.

– The $18,000 of rehabilitation costs incurred through the end of the calendar year within which the test period ends. The qualifying rehabilitation basis would be:

$4,000 + 146,000 + 18,000 = $168,000
========

NOTE: Although the test was met due to the $146,000 of rehabilitation costs incurred during the 24-month test period exceeding the $144,000 adjusted basis of the property at the beginning of the test period, the actual qualifying costs were $168,000. Once met, the test disappears and costs actually incurred qualify, including the following:

– Costs incurred prior to the 24-month test period,

– Costs incurred during the 24-month test period

– Costs incurred after the 24-month test period, but only through the end of the calendar year within which the test period ends.

Example 2

– "A" purchases the building on January 1, 1990 for $140,000.

– Rehabilitation Costs in 1990 were $4,000 per month for a total of $48,000 for the 1990 year.

– 1991 year rehabilitation costs incurred were $100,000.

– 1992 year rehabilitation costs were $2,000 a month for 10 months through October 31, 1992. (Total of $20,000 for 1992.)

– There were no long-term architectural plans, therefore, "A" is limited to a 24-month Substantial Rehabilitation Test period.

– “A” selects the measuring period beginning on March 1, 1990, and ending on February 28, 1992 (24 months).

– The beginning adjusted basis (for purposes of the test only), and based on the 24–month test starting date would be as follows:

– Purchase Price of $140,000 + 4,000 of Rehabilitation Costs for January 1990 + $4,000 of Rehabilitation Costs for February 1990 = $148,000.

Actual Test for Example 2

Acquisition 1-1-90 $140,000	Adjusted Basis $148,000 3-1-90	Actual Test Period (24 Months) Rehab Costs of $144,000	2-28-92	10-31-92
Rehab costs for 2 months @ 4,000 = 8,000 through 2-28-90		$40,000 in 1990 $100,000 in 1991 $4,000 in 1992	$16,000 additional costs through 10-31-92	

NOTE: The test is not met in this example because the rehabilitation costs of $144,000 did not exceed the beginning adjusted basis of $148,000 for the 24-month test period. Therefore, none of the costs prior to the test period, during the test period, or after the test period qualify.

THE 60-MONTH ALTERNATE TEST PERIOD

Mechanically, and from a law standpoint, the 60-month test period would work exactly the same as the 24-month test period with the only difference being the substitution of a 60-month period in place of the 24 months.

NOTE: The law sections indicate that to use the "60– month test period" the rehabilitation must be one that "may reasonably be expected to be completed in phases set forth in architectural plans and specifications completed before the rehabilitation begins."

MULTIPLE OVERLAPPING TEST PERIODS

Treas. Reg. section 1.48–12 provides for multiple test periods to be used to qualify costs incurred in years beyond those which are qualified through the end of the calendar year within which the test period ends.

In the two previous examples the test periods both ended with calendar year 1992 and would thus only qualify expenditures through the end of 1992 if the test was otherwise met. If the owner incurred expenditures in 1993, then a second test period would have to be selected which ended in 1993 to qualify expenditures in that year. To qualify expenditures in any given year, the test period must end at least one month within that year.

<u>BUILDING VERSUS SITE FOR PURPOSES OF THE SUBSTANTIAL REHABILITATION TEST</u>

Throughout the Internal Revenue Code, as written for the Historic Rehabilitation Tax Credit, the law addresses issues by continually referring to "building." Although the law mentions phased projects in various sections, the only actual example given highlights a phased project within a single building where the phasing actually relates to a four story building which will have two phases, with two floors rehabilitated during each phase.

As the "site" determination is one that would be made by the National Park Service or appropriate State Historic Preservation Office, the tax law as written does not specifically address how the "Substantial Rehabilitation Test" would be applied for a grouping of buildings determined to be a "site." As the law is silent in this area, and due to the continual emphasis on the "building" throughout the law, it is currently the interpretation of the Internal Revenue Service that the "Substantial Rehabilitation Test" should be applied on a building by building basis as they are placed in service, even though ultimate "certification" will be issued for the entire site.

This causes some practical dilemmas because the various buildings could be completed and placed in service and the owner entitled to take the credit (in the year placed in service, if the substantial rehabilitation test has been met) while it may be years before the ultimate "certification" is obtained for the "site" when the last building is completed. This is a good example of when a building owner would be required to make a "30-month notification" as required by regulation to notify Internal Revenue Service of the late or pending certification of a project for which they have previously taken the credit.

The issue of "substantial rehabilitation" and the Substantial Rehabilitation Test as the prescribed method to determine if substantial rehabilitation is achieved according to Congress' intent, has resulted in a very confusing area of the law. As examiners, it is beneficial to understand the intent of these provisions before trying to work with the mechanics prescribed to ensure compliance.

Congress determined that, in addition to having buildings rehabilitated to preserve both historical and older buildings, they also desired to have these building rehabilitations to be substantial. The test as included in both the Code and regulations makes the measurement process relative to the project size, and introduces a minimum threshold of rehabilitation expenditures of $5,000. To interject fairness into this "artificial" test as created by tax law, there is an allowance for the taxpayer/owner to select the measuring period based on the time frames of their project work.

As per tax law, the owner is required to identify their measuring period for purposes of the substantial rehabilitation test. As indicated in Item 15 on the Information Document Request, the measuring period and compliance with the substantial rehabilitation test should be pursued if the measuring period has not been disclosed on the return. The absence of either a measuring period or a notation referring to substantial rehabilitation on the return could indicate either ignorance of this particular provision by the building owner or a problem in meeting this test. With the above in mind, examiners should gather facts and documentation which will assist in determining if an issue exists regarding the substantial rehabilitation test.

Additional items for the IDR (see Exhibit 1–2) which may be helpful include Items 1, 2, 4, 9, 14, and 15. In a larger partnership situation, the offering memorandum outlines such items as acquisition costs, estimated costs of rehabilitation expenditures, and projected time frames within which the work will be done. Another helpful item would be the National Park Service filing, which outlines project costs, and starting and completion dates. The settlement sheet should establish the cost of the property/shell and also the acquisitions date. When determining the acquisition basis, the examiner may encounter situations where the owner, in making the allocation between land and shell, inflates the land basis and reduces the shell basis solely for purposes of making the project meet the substantial rehabilitation test. It has been found that many times, although not indicated per the return, the mechanics of the substantial rehabilitation test are addressed in the accountant's workpapers. The ledger accounts and formatted "draw" statements regarding the construction mortgage can be helpful in supporting not only the substantial rehabilitation test, but many other issues. The "draw" vouchers can also be used to establish costs during a given period, or indicate levels of completion at various times.

Finally, the underlying intent of the substantial rehabilitation test should be stressed when pursuing its practical implications. If a project is properly certified, or otherwise properly qualified, an examiner should make every attempt to identify the correct test period. Many owners/taxpayers claiming the credit do not include a measuring period with the return filed. In these cases, it is necessary to ascertain that substantial rehabilitation was achieved, and that 24-month or 60-month measuring period within which the test could be met existed.

SUBSTANTIAL REHABILITATION TEST LAW

Definitions/Qualified rehabilitated building. See IRC Section 47(c)

SUBSTANTIAL REHABILITATION REQUIREMENTS

See IRC section 47(c)(1)(C) and (D) and Treas. Reg. section 1.48–12(b)(1) and (2)

The 60-month alternate period for phased rehabilitations. See Treas. Reg. section 1.48–12(b)(2)(v)

Substantial Rehabilitation — Aggregate Expenditures. See Treas. Reg. section 1.48–12(b)(2)(vi) and (vii)

Statement regarding substantial rehabilitation test to be included with returns filed after August 27, 1985. See Treas. Reg. section 1.48–12(b)(2)(viii)

Substantial rehabilitation test at entity level for sub-S-Corporations and Partnerships. See Treas. Reg. section 1.48–12(b)(2)(ix)

Examples of application of the substantial rehabilitation test can be found in Treas. Reg. section 1.48–12(b)(2)(x).

COURT CASE

In *Alexander v. Commissioner*, 97 T.C. No. 15, the courts held that the taxpayer was not entitled to the Rehabilitation Credit based upon certain rehabilitation expenditures since those expenditures did not exceed the adjusted basis of the building as required by IRC section 48(g)(1)(C)(i)(I), (or undercurrent law 47(c)(1)(C)(i)(I)). The taxpayers rented the first floor of their personal residence and although the qualified rehabilitation expenditures allocable to the first floor exceeded the portion of the adjusted basis allocable to the first floor, the first floor is not a separate building within the meaning of IRC section 48(g)(1), (or under current law section 47(c)(1)(A)). Therefore, the credit was disallowed because the qualified rehabilitation expenditures did not exceed the adjusted basis of the entire building.

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Chapter 7

BASIS REDUCTION REQUIRED

BACKGROUND

The basis of the building must be reduced by 100 percent of the Rehabilitation Credit for purposes of computing depreciation, etc. An example of this basis reduction is as follows:

Example: land = $10,000
shell = $50,000
rehabilitation costs = $100,000

For purposes of depreciation, the basis of the project would be determined in the following manner:

– Land is not depreciable, and does not qualify for the credit.

– The shell does not qualify for the credit, but the full $50,000 would be allowed to be added to the basis for computing depreciation.

The rehabilitation costs of $100,000 qualify for the credit, and assuming a historical rehabilitation, the rate would be 20 percent. The Rehab Credit would be $20,000, ($100,000 X 20 percent). The depreciable basis of the rehabilitation costs would be $80,000, ($100,000 – $20,000).

The total depreciable basis would be $130,000 (80,000 + $50,000)

As previously noted, a straight line method of depreciation should be applied to the depreciable basis. Currently, basis would have to be depreciated over 27.5 years for residential rental, and 39 years for commercial properties. NOTE: If an adjustment is made to reduce the qualified basis and the resulting credit, then the previous basis reduction should be restored to the extent of the disallowed credit. This should be an automatic technical adjustment on any cases involving credit disallowances.

This issue may be evident from the return as filed. In other cases it may be necessary to review the owner's books and records the preparer's workpapers to determine if the appropriate basis reduction has made.

BASIS REDUCTION LAW

See Treas. Reg. section 1.48–12(e)

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Chapter 8

STRAIGHT LINE COST RECOVERY

BACKGROUND

The qualified rehabilitation expenditures, along with the shell, must be depreciated over a straight line depreciation period. Under the current law, a period of 27.5 years is used for residential rental property, and a 39-year period is used for nonresidential type properties.

NOTE: In all instances the property must be used in a trade or business or for the production of rental income. This is one of the few areas of rehab law where there is a court case to supplement existing law. The case, cited at the end of this chapter, indicates that if a Rehabilitation Tax Credit is taken and an accelerated method has been used instead of a straight-line method, then the credit as taken can be disallowed in full. In some cases it will be evident from there turn as filed that this issue exists, while in other cases it will be necessary to review the books and records, depreciation schedules, etc., to ascertain if the issue is present.

STRAIGHT LINE REQUIREMENT LAW

Straight line depreciation must be used in order to have "Qualified Rehabilitation Expenditures." See IRC section 47(c)(2)(B)(i)

Straight line depreciation must be used. See Treas. Reg. section 1.48–12(c)(7)(i) and (c)(8)(ii).

COURT CASES

Additionally, the Court Cases of *DeMarco v. Commissioner* (87 T.C. 518 (1986), *Manning v. Commissioner* (T.C. Memo 1993–127), and *Au v. Commissioner* (T.C. Memo 1990–203), can be used to address the issue of an accelerated method being used in cases where Rehabilitation Tax Credits have been taken.

In *DeMarco*, the Tax Court indicated that the taxpayer's failure to use a straight line method of depreciation on either their original, or amended return, disqualified them from taking a Rehabilitation Tax Credit.

In *Manning*, the Rehabilitation Credit was disallowed because the taxpayer failed to elect to depreciate the expenditures under an approved straight-line method. In *Au*, no Rehabilitation Tax Credit was allowed for rehabilitation Tax Credit was allowed for rehabilitation expenditures where the owners failed to affirmatively elect to use the straight-line ACRS method of depreciation.

Chapter 9

CREDIT RECAPTURE ON DISPOSITION

BACKGROUND

Congress intended that the rehabilitated buildings be retained by the first owner to place the building in service after the rehabilitation is completed and is entitled to take the credit. A 5-year recapture period is prescribed by law. The recapture period is 5 full years from the original date as "placed in service," and is equal to 20 percent of the original credit as taken for each year less than 5 full years that the property is held by the owner in an income producing activity.

A recapture would be triggered by a disposition of the property by the owner or when the property ceases to be income producing. The examiner should ascertain whether there has been a disposition of the property by using local property records, inspecting the premises, questioning the owner/taxpayer, etc. If it is determined that there was a disposition of the property, then the examiner should ascertain the specific date "placed in service" and the date of disposition using available evidence, such as a settlement sheet or property records, to calculate the recapture using the full year recapture provisions of IRC section 50.

CREDIT RECAPTURE LAW

Credit Recapture Upon Disposition of Building/Rehabilitation

Recapture in Case of Dispositions, etc. See IRC Section 50(a).

Credit recapture upon disposition of building/rehabilitation. IRC section 47 (5 Year Recapture) provisions apply. See Treas. Reg. section l.48–12(f)(3).

COURT CASE

In *Rome I, Ltd. v. Commissioner*, 96 T.C. No. 29, the court held that the grant of a historical facade easement constitutes a disposition for purposes of IRC section 47, (or IRC section 50 under current law). The taxpayer had to recapture the portion of the rehabilitation credit which is attributable to the facade easement and reduce its basis in the underlying property upon granting of the facade easement. This situation would only occur if the facade easement is granted subsequent to the building being placed in service for a period of time.

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Chapter 10

NO CREDIT FOR ACQUISITION COSTS

BACKGROUND

All structural components of the building normally qualify as basis for the Rehabilitation Credit, as well as some additional items outlined by the Internal Revenue Code, regulations, and court cases. Acquisition costs, or related costs incurred for the acquisition of the original shell, and land do not qualify for purposes of the Rehabilitation Credit. They are specifically excluded from the definition of qualified rehabilitation expenditures.

The cost of acquiring any building or interest therein, including a leasehold interest, pre-rehabilitation costs or the cost of acquiring a previously rehabilitated building that was already placed in service do not qualify. These costs are still includible in the depreciable basis. This issue is examined through the documents requested as Items 4, 9, and 12 of the sample Information Document Request (see Exhibit 1–2), in addition to local property records. Inspection of the settlement sheets, and the accountant's workpapers would disclose the acquisition basis or depreciable basis. Any financing agreements, or mortgages would also provide this information, as well as information regarding the acquisition interest. If this documentation is not readily available, the information can be obtained through local property records. If an examiner determines that acquisition costs were included in the credit basis, the costs should be removed from the credit basis and the depreciable basis should be restored.

ACQUISITION COST LAW

Acquisition costs are not includible in qualified rehabilitation expenditures. See IRC section 47(c)(2)(B)(ii).

Acquisition costs not includible certain expenditures not included in qualified rehabilitation expenditures. See Treas. Reg. section 1.48–12(c)(7)(ii).

Acquisition costs include interest on acquisition of the property/shell. See Treas. Reg. section l.48-l2(c)(9)

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Chapter 11

ENLARGEMENT COSTS EXCLUDED
(Some Demolition Costs also Excluded)

BACKGROUND

The Internal Revenue Code also contains a section dealing with enlargements or additions to rehabilitated buildings. The costs of additions are not includible in the qualified Rehabilitation Credit basis. This issue is usually more prevalent in non-certified rehabilitations, due to the lack of the State Historic Preservation Office or National Park Service involvement in these projects.

The National Park Service (NPS) review files are particularly helpful for developing this issue in historical rehabilitation cases as these files usually contain documentation to establish the extent of the addition. Part II of the NPS application contains questions regarding the before and after square footages of the building as rehabilitated. It has also been found that the AIA formatted construction vouchers will usually be separated to reflect an addition if it is of a material nature, or will contain a separate line item for the respective addition. Once it has been determined that an addition is present, the examiner should determine the costs incurred in relation to that addition. If costs are not separately stated, then the examiner should ensure that a reasonable allocation of project costs has been made. If not, an adjustment to more properly reflect the costs related to the addition is appropriate. Items 2,9, 13, and 14 of the IDR (see Exhibit 1–2) should be helpful in establishing cost of additions. If an addition appears to be significant and the cost allocations appear to be inaccurate, then the use of an engineer on the case should be considered.

Another nonqualifying rehabilitation cost is any demolition cost which ultimately lead to the complete removal of the building. The key to remember is that if the building exists after the demolition, then the costs of that demolition would qualify for inclusion in the Rehabilitation Credit basis. If a building is completely destroyed by the demolition, then there is no rehabilitated building and, therefore, no qualifying rehabilitation basis.

Generally, all rehabilitations involve some demolition referred to as "light interior demolition" and usually consists of interior work to reconfigure areas or to clean out an older abandoned building prior to the rehabilitation. These costs qualify as long as the project is certified by the National Park Service, or as long as the wall retention requirements have been met as previously discussed in Chapter 3, Non-Historic Credits, for a non-certified rehabilitation.

The issue of demolition costs and their treatment is probably most prevalent in cases involving a "historical site." Normally, the National Park Service reviews and certifies projects on a building by building basis. There are occasions where properties containing more than one building will be rehabilitated. In these situations, the project will be reviewed and certified in its entirety by the National Park Service. The National Park Service may allow for demolition of some of the component buildings as long as the majority of the buildings are maintained and rehabilitated. In this situation, the costs of the buildings which were completely demolished cannot be added to the costs of the remaining buildings and included in the qualified rehabilitation tax credit basis. The taxpayer's books and records can give indications of entire building demolitions. A review of the National Park Service files may also contain entire site maps with legends for proposed or actual demolitions of entire buildings.

Finally, the examiner should use Items 4, 5, 9, 13, and 14, as outlined on the sample IDR (see Exhibit 1–2) to determine if a demolition issue exists. Both Settlement Sheets and Certificates of Occupancy could give indications of multiple buildings. The books and records, particularly the depreciation schedules, may also contain indications of multiple buildings and possible demolition. The construction contract and AIA construction vouchers are another source of documentation for significant demolition costs and demolished buildings. NOTE: If the entire structure is demolished, all costs related to the acquisition and subsequent demolition of the particular structure shall be treated as land and charged to that capital account with no current tax recognition.

ENLARGEMENT EXPENDITURES LAW

Enlargement expenditures not included in qualified rehabilitation expenditures. See IRC section 47(c)(2)(B)(iii) and Treas. Reg. section 1.48–12(c)(7)(iii).

Enlargement is defined in Treas. Reg. section 1.48–12(c)(10)

Chapter 12

SITEWORK EXPENDITURES EXCLUDED

BACKGROUND

Site work expenditures, including any landscaping, sidewalks, parking lots, paving, decks, outdoor lighting remote from the building, fencing, retaining walls, or similar expenditures to areas related to the building, do not qualify for purposes of the Rehab Credit. These items are specifically excluded from the definition of qualified rehabilitation expenditures because they are not considered made in connection with the rehabilitation of a qualified rehabilitated building.

Items 2, 9, 13, and 14 of the Information Document Request (see Exhibit 1–2) address this issue. Review of the National Park Service certification application file is particularly helpful in developing this issue. Part 3, Request for Certification of Completed Work contains a question regarding estimated costs attributable to sitework and other excludible items. The file may also contain pictures which clearly show the type of sitework done. It has also been found that the AIA formatted construction vouchers and the construction contract will often reflect the costs attributable to sitework separately.

Certain sitework expenditures (such as landscaping) maybe immaterial, but parking lots and paving expenditures can result in a considerable adjustment. If an examiner determines that sitework expenditures were included in the credit basis, the costs should be removed from the credit basis and the proper depreciation allowed.

SITEWORK EXPENDITURES LAW

See Treas. Reg. section 1.48–12(c)(5)

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Chapter 13

PERSONAL PROPERTY EXCLUDED

BACKGROUND

Personal property or furnishings, including any furniture and appliances, cabinets and movable partitions or carpeting, (if tacked in place versus glued) do not qualify for purposes of the Rehabilitation Tax Credit. The major expenditures to be removed from the qualified rehabilitation basis of most projects are the appliances and carpeting in residential rental or condo units. Refer to the law sections, court cases, and rulings below for more examples of personal property. Essentially, personal property is defined as "Section 38 Property" or Investment Tax Credit Property. These items are specifically excluded from the definition of qualified rehabilitation expenditures because they do not relate to the building or its structural components.

Items 9, 13, and 14 of the Information Document Request (see Exhibit 1–2) address this issue. Inspection of the construction contract and the AIA statements could disclose items which are considered personal property. Also, the absence of these items on the depreciation schedule could be an indication that these items were included in the credit basis.

If an examiner discovers that the credit basis includes items which are considered personal property, the costs should be removed from the credit basis and the proper depreciation allowed. In this case, the straight-line method is not required and any accelerated method is allowable.

PERSONAL PROPERTY LAW

Personal Property Items/Non-Structural Components.

See:

IRC section 47(c)(2)(A)

Treas. Reg. section 1.48–1 — Definition of IRC Section 38 property.

Treas. Reg. section 1.48–1(c)

Treas. Reg. section 1.48–1(e)

Treas. Reg. section 1.48–11 Personal Property/"IRC section 38 property" items are excluded from qualified rehabilitation expenditures. Treas. Reg. section 1.48–11(c)(6)(i) states that certain expenditures are excluded from qualified rehabilitation expenditures.

COURT CASES, REVENUE RULINGS, AND SENATE FINANCE COMMITTEE REPORT

Court Cases

In *A. Liebl,* (DC)72–2 U.S.T.C. 9581, ranges and refrigerators installed in apartments rented otherwise unfurnished were ineligible for the investment tax credit but the reasoning was because they were property used in a lodging facility.

In *Alabama Displays, Inc,* Ct. Cl., 75–1 U.S.T.C. 9116,507 F.2d 844, *National Advertising Co.*, Ct Cl. 75–1 U.S.T.C. 9117, 507 F.2d 850 and *Whiteco Ind Inc.*, 65 T.C. 664, DEC 33,594, billboards for outdoor advertising purposes were tangible personal property and qualified for the investment credit.

In *Minot Federal Savings and Loan Assn.*, (CA-8) 71–1 U.S.T.C. 9131, 435 F.2d 1368, it was found that removable partitions, which were not permanent and could be changed and moved without injury to the building, qualified for investment credit.

In *S. Mandler*, 65 T.C. 586 DEC 33,500, coin operated washing machines and dryers leased for use in apartment buildings were eligible for the investment credit. The machines were not used predominantly in connection with the furnishing of lodging because they were accessible to non-residents as well as tenants.

Revenue Rulings

In Revenue Ruling 65–79, 1965–1 C.B. 26, bank vault doors, record vault doors, night depository facilities, and walk up and drive up teller windows which constitute depreciable units, are tangible personal property and qualify as IRC section 38 property. Drive up teller booths are considered buildings and do not qualify. Revenue Ruling 67–349, 1967–2 C.B. 48, stated that wall-to-wall carpeting as installed in the guestrooms, office space, bar areas and dining rooms of the motel buildings in this case, is tangible personal property within the meaning of IRC section 1.48–1(c)of the income tax regulations and will qualify as "IRC section 38" property for investment credit purposes provided it is depreciable property having a useful life of four years or more.

In Revenue Ruling 81–133, 1981–1, furniture leased to owners and operators of apartment buildings, duplex houses, and similar establishments that lease those facilities to tenants for periods of more than 30 days is property used in connection with the furnishing of lodging and is not IRC section 38 property for investment credit purposes. However, furniture leased directly to tenants of those facilities qualifies as IRC section 38 Property.

Senate Finance Committee Report

In the Senate Finance Committee Report for the 1978 Revenue Act (P.L. 95–600), the following items were listed as qualifying for the investment credit (IRC section 38 property) as tangible personal property under existing law (highlights committee intent); special lighting, false balconies, exterior ornamentation, identity symbols such as materials attached to the exterior or interior of the building, signs, floor coverings which are not an integral part of the floor, carpeting, wall panel inserts, beverage bars, ornamental fixtures, artifacts (if depreciable), booths for seating, movable and removable partitions, large and small pictures which are attached to walls or suspended from the ceiling.

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Chapter 14

TAX EXEMPT USE PROPERTY

BACKGROUND

Both IRC section 47(c)(2)(B)(v) and Treas. Reg. section 1.48–12(c)(7)(vi) indicate that the term "qualified rehabilitation expenditures" does not include tax exempt use property. That is, "any expenditure in connection with the rehabilitation of a building which is (or may reasonably be expected to be) tax exempt use property (within the meaning of IRC section 168(h))."

The above clause does not apply for purposes of determining whether a building has been "substantially rehabilitated." Even if determined to be tax exempt use property, expenditures related to that portion of the building can still be counted in order to make the"substantial rehabilitation" test and qualify other non-tax exempt portions of the building.

Whether a building, or portion of a building, is considered "tax exempt use" property depends on more than just the fact that one of the occupants leasing the building (or a portion of the building) happens to be a tax exempt entity. The law sections cited below reflect the introduction of a tax concept titled "Disqualified Lease," which clarifies that otherwise qualifying expenditures would not be includible due to their "tax exempt use" status and transactions which fall under the tax definition of a "Disqualified Lease."

Extract

IRC section 168(h)(i)

*** tax exempt use property" means that portion of the property leased to a tax-exempt entity in a disqualified lease.

Extract

IRC section 168(h)(ii)

*** "disqualified lease" means any lease of the property leased to a tax-exempt entity, but only if ––

(I) part or all of the property was financed (directly or indirectly) by an obligation the interest on which is exempt from tax under section 103(a), and such entity (or a related entity) participated in such financing.

(II) under such lease there is a fixed or determinable price purchase or sale option which involves such entity (or a related entity) or there is the equivalent of such an option.

(III) such lease has a term in excess of 20 years, or

(IV) such lease occurs after a sale (or other transfer) of the property by, or lease of the property from, such entity (or a related entity) and such property has been used by such entity (or a related entity) before such sale (or other transfer) or lease.

35-Percent Threshold Test

The clauses above will apply to any property only if the portion of such property leased to tax exempt entities in disqualified leases is more than 35 percent of the property.

The term "Tax Exempt Entity" means the United States, any state, or political subdivision thereof, any possession of the United States, or any agency or instrumentality of any of the foregoing, an organization which is exempt from income tax, and any foreign person or entity.

Various issues can evolve from transactions with, and the leasing of real estate to, a tax exempt entity or entities. Examiners can use requested items from the Information Document Request (see Exhibit 1–2) to pursue issues. Items 1, 4, 6, 12, and 17 could be helpful in detecting this issue. In some instances, the "Offering Memorandum" could disclose if there are negotiations with, or the signing of a lease with, a prospective Tax Exempt Entity tenant. Review of the settlement sheet may disclose who the former owner of the building was, or indicate a sale/leaseback with a tax exempt entity.

Review of the leases of a rehabilitated building is an audit step to determine "placed in service" dates, but may also be used to ascertain if there are tax exempt entities leasing the building. Financing agreements and loan records can also produce evidence of tax exempt financing under IRC section 103. Inspection of the completed rehabilitated building may also evidence tax exempt entities via the building directory, etc.

If either part or all of a building is "Tax Exempt Use" as defined by the cited law sections, then there will be a disallowance of the credit attributable to that portion of the property.

TAX EXEMPT USE LAW

Special rules for rehabilitation of tax exempt use property. Tax exempt use property not qualified rehabilitation. See IRC section 47(c)(2)(B)(v).

Tax exempt use property not considered qualified rehabilitation expenditures. See Treas. Reg. section 1.48–12(c)(7)(vi).

Note: See other provisions under IRC section 168(h) for further clarification of what constitutes Tax Exempt property.

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Chapter 15

EXPENDITURES OF LESSEE

BACKGROUND

The term "qualified rehabilitation expenditures" specifically excludes expenditures of a lessee of a building (or a portion of a building) unless the lease, without regard to renewals, is longer that the recovery period of the building, (27.5 years for residential and 39 years for non-residential rental property). If the lease is considered a long-term lease, a credit can be taken for the lessee expenditures by the person who has incurred the costs. This creates a situation where the owner and several lessees of a building could all qualify for the rehabilitation test as long as the aggregate expenditures of all parties are considered when determining if the project meets the substantial rehabilitation test.

Items 9, 13, and 14 of the Information Document Request (see Exhibit 1–2) address this issue. Construction contracts and AIA vouchers may show items built to tenant specifications and separate billings to the lessee. The workpapers may also show lessee/tenant expenditures for each unit and/or amounts reimbursed by the lessee. If the examiner discovers that the credit basis includes lessee expenditures or if a lessee is claiming a credit for lessee expenditures incurred, the examiner should inspect all leases to determine if the lease is considered long-term as determined by the initial term of the lease without regards to any renewal periods or options. If the lease is not considered long-term, the examiner should remove the portion of the credit basis which pertains to lessee expenditures, or disallow the lessee's credit and allow the proper depreciation.

LESSEE EXPENDITURES LAW

Lessee expenditures only qualify if the term of the lease is more than the recovery period of the building for depreciation. See IRC section 47(c)(2)(B)(vi) and Treas. Reg. section 1.48–12(c)(7)(v).

COURT CASE

In *S.G. Eubanks*, 59 TCM 529, Dec. 46,567(M), T.C. Memo, 1990–227, no rehabilitation credit was allowed where the remaining term of the lease was less than the period prescribed by statute for amounts expended by a lessee which were considered qualified rehabilitation expenditures.

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Chapter 16

CONSTRUCTION INTEREST & TAXES

BACKGROUND

The interest on the construction loan (as incurred during the construction period) is includible in the Rehab Credit basis. This is also true for the taxes incurred during this period. Once the building is placed in service, the interest and taxes are considered period expenses no longer chargeable to the capital account. There are some instances where a portion of the construction loan is used for the acquisition of both a building (or shell) and land. An allocation should be made using a reasonable method; the interest pertaining to the acquisition financing would be a period expense and any other interest chargeable to a capital account during the construction period would be allocated to the Rehabilitation Tax Credit basis. The amount of interest attributable to the acquisition of the building, an interest in the building, or the land on which the building exists is specifically excluded from the term "qualified rehabilitation expenditures."

Items 4, 5, 6, 12, 13, and 14 on the Information Document Request (see Exhibit 1–2) address this issue. Inspection of the settlement sheet, construction contract, AIA construction vouchers, and financing agreements or mortgages, could disclose interest attributable to either acquisition or construction. The Certificate of Occupancy, and copy of first lease executed would be used to verify when the building was placed in service. Any interest expense and real estate taxes incurred subsequent to the building being placed in service or relating to the acquisition would be expensed in the year incurred or paid, and should be removed from the qualifying Rehabilitation Tax Credit basis.

CONSTRUCTION INTEREST & TAXES LAW

See IRC Section 266. Carrying Charges

Acquisition costs include interest on acquisition of the property/shell. See IRC section l.48-l2(c)(9)

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Chapter 17

PROGRESS EXPENDITURES

BACKGROUND

In general, the Rehabilitation Tax Credit can only be claimed when the building is placed in service. A taxpayer can make an election to claim the Rehabilitation Tax Credit for qualified rehabilitation expenditures on qualified "progress expenditure property." Qualified "progress expenditure property" is any property which has a normal construction period of 2 years or more, and which will be a qualified rehabilitated building in the hands of the taxpayer when it is placed in service.

The 2-year construction period begins on the first day the rehabilitation begins or the first day of the taxable year which the election is made, and ends when the building is available to be "placed in service." Any expenditures which are incurred prior to the beginning of the 2-year period do not qualify as progress expenditures. Expenses do not qualify as progress expenditures in the year the property is placed in service, or in the year the credit is recaptured under IRC section 50(a), if applicable.

Qualified progress expenditures are amounts chargeable to the capital account during the taxable year for self-rehabilitated property if more than half of the rehabilitation expenses for the property are made directly by the taxpayer. If the property is not self-rehabilitated, qualified rehabilitation expenditures would be the lesser of amounts paid during the taxable year to another person for rehabilitation of the property, or the amount which represents the portion of the taxpayer’s total cost for the rehabilitation by the other person which is properly attributable to the rehabilitation completed during the taxable year. Any amount not allowed in the current year would be carried over to the subsequent year.

Although the law is silent to the application of the substantial rehabilitation test, it is currently the Service’s position that the substantial rehabilitation test must first be met before progress expenditures would qualify in a given year. Refer to Chapter 6, Substantial Rehabilitation Test, for auditing techniques and the law to support the substantial rehabilitation requirements.

A credit based on the progress expenditure method constitutes an election under this section. However, the progress expenditure method is used very infrequently when compared to the conventional method based on placed in service. NOTE: in a situation where "placed in service" is the correct timing for taking the credit and the Service is raising an issue regarding the building (or a portion of the building) not being placed in service timely, the taxpayer should not be allowed to use the progress expenditure method regarding the disallowed items.

PROGRESS EXPENDITURE LAW

Refer to IRC Section 47(d)

Chapter 18

FACADE EASEMENT

BACKGROUND

If all or a portion of the building is disposed of, either by sale or gift, the credit recapture provisions of IRC section 50(a) apply, (refer to Chapter 9, Credit Recapture on Disposition). In addition, if the taxpayer does not legally own all or part of the building, they are not entitled to claim the rehabilitation tax credit. Either of these two situations apply if there is a conveyance of a "facade easement," either by sale or gift.

Once the building and rehabilitation are "certified" by the Department of the Interior, an owner of a building can create and either sell, or donate, the facade easement. In a situation where the facade easement is sold, the taxpayer must reduce the basis of the underlying property. If the sale is made in the year that the building is placed in service, and the credit is taken, the portion of the basis of the building, land and rehabilitation allocable to the facade easement would be removed from both the credit and the depreciable basis and neither credit nor depreciation would be taken on that portion. If the sale is made subsequent to the building being placed in service and prior to the close of the useful life taken into account when computing the credit, the recapture provisions under IRC section 50(a), (prior to 1991, under IRC section 47(a)), would apply.

In the situation where there is a sale of the facade easement to a local historical society, no charitable contribution is allowed and the gain is computed. The sale of a facade easement is rare. Usually, the facade easement is granted or donated to a local historical society and, in some instances, a cash user fee to fund the enforcement commitment of the group into perpetuity is paid to that society. As in a sale, the credit and depreciable basis are reduced and no credit or depreciation is taken on the portion of the building, land, and rehabilitation basis. If the donation is made subsequent to placing the building in service, the credit recapture provisions of IRC section 50(a) apply. In this situation, the taxpayer may be allowed a charitable contribution deduction for the qualified conservation contribution as set forth under IRC section 170(h) and Treas. Reg. section 1.170A-14. In addition, the cash user fee is also allowed as a charitable contribution. A qualified conservation contribution is defined as the contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes, and such property must be protected in perpetuity.

Once the sale or disposition is made, the basis of the remaining property and the disposed property must be determined. To determine the proper allocation, the fair market value of the building (after the rehabilitation), land, and facade must be determined before the granting of the facade. In most cases, the taxpayer will obtain an appraisal for the facade easement.

The engineers in the Philadelphia District conducted a seminar with appraisers and real estate professional from the outside and concluded that proper valuation of a facade easement should range from approximately 10–15 percent of the value of the property. Subsequent to this seminar, the problem was not in the valuation of the easement, but the treatment of the facade easement. Once the fair market values have been determined, the same ratios are used to allocate the basis of the building and the underlying land to the facade easement for both credit and depreciation purposes.

Items 1, 2, 7, and 9 of the Information Document Request (see Exhibit 1–2) could be helpful with this issue. The Prospectus/Offering Memorandum should disclose if there was a grant or sale of the facade easement. The building which relates to the facade easement must be separately listed on the National Register of Historic Places. If located in a historic district, Part 1 Certification of the Building must be obtained from the Department of the Interior stating that the building contributes to the significance of that district. The deed, appraisal, and the accountants workpapers would be needed to determine to whom the facade easement was conveyed and how the basis was determined. Local real estate records would also disclose the encumbrance on the building, the holder of the deed, and the value of the facade easement. An examiner should be sure that the person controlling the ownership interest in the building does not have a controlling interest in the local historical society. There must be independence between the two so that the encumbrance could not later be removed to facilitate a sale and defeat the purpose of the easement conveyance.

FACADE EASEMENT LAW

See IRC section 170(h)

Refer to Chapter 9, Credit Recapture on Disposition, for the law and explanations regarding the recapture provisions and Treas. Reg. section 1.10A-14 for further explanations regarding Qualified Conservation Contributions.

COURT CASE AND REVENUE RULING

Court Case

Rome I, Ltd., E.C. Systems, Inc., Tax Matters Partner v. Commissioner, 96 T.C. No. 29, petitioner's grant of a historical facade easement constitutes a disposition under IRC section 47(a), (or IRC section 50(a) undercurrent law).

The courts determined that upon donation of a facade easement, there is a partial disposition, and the recapture provisions of IRC section 47(a), (or IRC section 50(a)), shall apply, therefore, the basis must be accordingly reduced. In this case the petitioners/owners granted the easement at the time the building was placed in service and the credit was taken but they did not reduce the basis of the credit and the property by the value allocated to the easement.

Revenue Ruling

Revenue Ruling 89–90 Certain Dispositions of IRC Section 38 Property Which trigger Recapture under IRC Section 47, (or 50), of the Code.

The ruling states that upon conveyance of a facade easement, either by sale or gift, there is a recapture of a portion of the rehabilitation credit. The ruling discusses the donation rules under IRC section 170(h), and the disposition and recapture provisions under IRC section 47(a), (or IRC section 50(a)).

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Chapter 19

DEVELOPER FEES

BACKGROUND

One of the most material issues encountered on Rehabilitation Tax Credit cases is the inclusion of development fees in the reported qualified basis of the projects. The "characterization" of these various fees as purportedly incurred for "development," as well as the percentage charged in relation to the "hard costs" of the various projects, have made them uncertain as properly qualifying rehabilitation expenditures. The law sections for rehabilitation indicate that developers fees are includible in the qualifying rehabilitation basis. The flaw in the law section is that the term "developer fee" or "development fee" is never defined. The general idea of allowing the inclusion of a cost in the basis, without defining what is properly includible, can lead to significant credit disallowances and tax changes once the real character of the costs incurred had been determined.

The text which follows attempts to identify the potential issues regarding developer fees and highlight any possible forms the developer fees may take, the applicable law sections, and positions successfully taken to address the various issues encountered regarding developer fees.

To successfully address potential developer fee issues, an examiner must first identify various aspects regarding the developer fee as it has been included in the rehab project under examination. The primary task is to identify the following:

1. The amount of the developer fee and how it was to be paid, (cash or note). Determine if the cash payments, and payments per any notes or financing, were actually paid to date.

2. How the developer fee amount was determined, (for example, based on arms-length negotiations, etc.).

3. The developer. Note: if the developer is an entity, determine who is behind that entity; identify the ownership through any tiers, etc., which may have been layered to insulate the real owner of the developer entity.

4. In addition to the above, trace the entire series of transactions to specifically identify all entities, and who owns/controls them.

5. The developer fee mechanism.

   a. Turnkey Project — Where the partnership enters into a development agreement with a developer to pay an amount which includes all hard construction costs and the balance is earned by the developer as the developer fee. An example of this arrangement would be a situation where the development agreement calls for a payment of $2 million with the estimated hard costs of the project budgeted at $1,200,000. If the actual costs are consistent with the budgeted amounts then the developer will have earned a fee of $800,000. NOTE: The key factor to establish in this case is what type of service the "developer" has performed to justify this compensation or fee, and how these amounts should be "characterized" for tax purposes. The partnership/owner usually acquires the building before the development contract is entered into. There may be a variation of this turnkey situation where, in addition to contracting for the development of the project, the shell purchase is also included in the contract price.

   b. Fixed Amount Developer Fee — A fixed amount developer fee occurs in a situation where the "hard costs" and the developer fee are separately stated items. The developer fee is usually based on the estimate or budget for hard costs. For example, $1 million of hard costs with a developer fee added in a fixed amount of $150,000. In this situation, the partnership/owner has usually already acquired the shell prior to entering into the development contract. Unlike a Turnkey Agreement, the developer fee does not decrease if the hard costs exceed their budgeted amounts.

   c. Completed Project Developer Fee — A completed project developer fee is one which is passed on to the ultimate purchaser of the building as a component of the purchase price. The building in this case is sold as a completed package after the rehabilitation work is finished. The sales price includes components or costs for the original land, shell, rehabilitation costs, and any development costs or other "soft costs." The primary task is to determine what the components of the purchase price are, who was involved in the transaction, what their purported role in the transaction was, and what their real role was in the transaction. This analysis will probably lead to conclusions which include "substance versus form" arguments. To make this argument, the facts and transactions must be established, and the players and their roles properly identified. If done correctly, a good and substantive argument for "recharacterization" of these soft costs can be made. These costs are not includible in the rehabilitation tax basis, depreciable, or amortizable, etc. Depending on the size of the project or the materiality of the fees involved, substantial adjustments may be warranted. NOTE: In some cases the partnership may be buying one or more condominium units in a completed project. If this is the case, then an additional issue may be involved due to extensive sales and marketing expenses which are passed through to the purchaser when the condominium units are sold. Although these costs can be included in the basis for depreciation purposes they do not qualify for inclusion for purposes of the Rehabilitation Tax Credit.

d. Failed Project Developer Fee — A developer fee under either a Turnkey Agreement or a Fixed Amount Developer Agreement may be evident in another type of project which is commonly referred to as a "Failed Project." The key factor to remember in this situation is that the failure referred to is usually one in terms of depleted finances or total bankruptcy of a former owner. Usually the salvaging of this project by the new developer depends upon their ability to syndicate and sell this project to a new group of investors. Enough capital must be generated to buy the project, complete the remaining rehabilitation items, and also cover the "soft costs" incurred for the services of the individuals involved in completing the project. As in all the above scenarios the identification of all the transactions and players is imperative in raising any issues regarding fees or soft costs.

In addition to the identification of the particular developer fee scenario, there are various examination techniques which can be employed and some Information Document Request items which can be beneficial in developing these issues. Note that Items 1, 4, 9, 11,12, 13, 14, and 17 on the IDR (see Exhibit 1–2) may pertain to this issue. In most instances the Offering Memorandum for a syndicated partnership will probably discuss the transactions of the partnership, including any development contracts to be entered into or development fees to be paid. Offering Memorandums are also beneficial in that the parties to the various transactions will be disclosed; particularly if there are conflicts of interest which would signal transactions which are not at arms-length. On occasion, the settlement sheet will actually contain not only the purchase of the shell, but also all development costs. Workpapers used to prepare the tax return, and audit workpapers (if one was performed by the accountant), may also contain narrative and numbers related to a development contract or fees. Bank statements and canceled checks could evidence payments made as developer fees or related to a development contract. Financing agreements, particularly for construction financing, also assist in making determinations regarding the propriety of developer fees. Both the construction contract and the AIA, (American Institute of Architects) formatted construction vouchers provide insight into the size of the project, the "hard costs", the time frames and degree of completion at various intervals throughout the construction period, etc.

Based on both past and current tax law provisions dating from 1976 through 1993, developers fees are an allowable part, or component of the "qualified rehab basis." However, when the transactions are analyzed and the facts established, there are opportunities for adjustments to recharacterize items that are not development fees, but have been characterized as such to increase nonqualifying costs included for computation of the Rehabilitation Tax Credit basis. Examples of expenses which may be incorrectly characterized to obtain tax benefits include:

1. Syndication Costs — The cost of syndicating a partnership and its related investment units. Syndication costs are normally items incurred for the packaging of the investment unit, (the partnership unit), and the promotion as an investment; including any marketing of the actual units, the production of any Offering Memorandums or promotional materials, the mobilization of any brokers/dealers who will sell the partnership units and the actual sales commissions paid to the sellers of the partnership whether they be unrelated third parties or the individuals who promoted the investment. Note that the individual or entity who acts as the developer may have been involved in the syndication aspects of the project, including the structuring of the investment unit, the work necessary to coordinate and effectuate the promotion of the investment units through syndication, and the subscription for the partnership units. Also note that the developer, in many instances, is the one who originally created the investment units. The individual or entities involved in the project will characterize all of their activities as "development" in nature, and will include the associated costs in the Rehabilitation Tax Credit basis. Under IRC section 709 these costs should not be currently expensed, or amortized, and are not includible in the qualified rehabilitation basis for purposes of the Rehabilitation Tax Credit; nor are they includible for depreciation purposes.

2. Organization Costs — The cost of organizing a partnership should be amortized over a period of time not less than 60 months. This organization cost should include the legal and accounting costs necessary to organize the partnership, facilitate the filings of the necessary legal documents, and other regulatory paperwork required at the state and national level. In addition to the requirement that these costs be amortized, they are not includible in the Rehabilitation Tax Credit basis nor are they allowable for depreciation purposes.

3. Acquisition Costs — Under the provisions of IRC section 47, (formerly IRC section 48(g)), the costs of acquiring the shell before rehabilitation are not properly includible in the qualified rehabilitation basis. These costs may be passed on to the partnership in the purchase price of a completed project. If the partnership purchased the building before rehabilitation then there are two components which must be identified. The actual cost of the land and shell can be identified through review of the settlement sheet while additional indirect costs of acquisition are more difficult to detect. These indirect costs include amounts paid to the promoters who have actually purchased the property on behalf of the partnership. The compensation for the promoters services will be characterized as developer

fees rather than acquisitional costs to qualify them for the rehabilitation credit. These costs may be significant (depending on the size of the project) because promoters will complete feasibility studies to determine if they want the property. Also, buildings may be purchased months or years prior to rehabilitation and extensive "holding costs" may be incurred. Throughout this time period, the promoter's services are necessary and reimbursements for these services are made.

4. Rent Up/Lease Costs — "Rent up" or "lease up" costs are the costs necessary to fully rent the newly renovated building. This initial rental can take several years and costs can be extensive; including advertising, sample unit costs, on-site rental managers and staff, initial rental incentives, and any other costs to fully rent out the buildings. These costs should be amortized over the life of the leases if long term, but if short term then the amortization should be over the period necessary to rent out all units, (24 months or 36 months).

5. Rental Management — The continuing day-to-day management of the property including all dealings with the tenants, renewal of current leases, procurement of new tenants for any vacancies, etc. Rental management fees are usually a set amount plus 6 percent for any lease renewals and incentives for new tenants obtained to fill vacancies. These amounts should be expensed on a yearly basis and matched against current rental income.

The above costs are the most common expenses included in the Rehabilitation Tax Credit basis. If additional categories or terminology is encountered, determine what they were for, how paid, and who received the payment. An analysis will then be necessary to determine the proper tax character.

Based on the above discussion and cases encountered in the Philadelphia District, a position was developed to address cases involving developer fees. Some fees were as high as 100 percent of the project's hard construction costs. Even allowing consideration based on arguments that to rehabilitate an existing building according to the historical standards was more difficult than undertaking new construction, these fees were inordinate when compared to arm's length transactions. The development of the facts surrounding the fees and what services were really provided to warrant the fees are the items that will support the position, and make adjustments plausible.

Look at Exhibit 19–1. It is a sample report which can be used to address the development fee issue. This position was tested in a Tax Court Case which the Service won. Details regarding the Tax Court Case will follow this position in synopsis form. For purposes of this guide, fictitious names have been used. This report can be adapted to address various different developer fee scenarios.

SUMMARY

The case presented in the sample report (Exhibit 19–1) is *Richard E. Kara and Mind Kara v. Commissioner*, and *Franklin D. Zuckerman and Lois Zuckerman v. Commissioner*, T.C. Memo 1991–436. The court determined that the partners/developers failed to establish that they performed any of the services relating to the renovation of the property as set forth in the development agreement and it was found, as developed by the examiner, that most of the services had actually been performed by a third party under a separate agreement and for which that third party was separately compensated. As previously indicated, factual development of these cases is imperative.

The sample report can be modified to accommodate various situations involving development fees. However, recharacterization of credit and depreciable basis amounts must be support by adequate factual development. Cases with similar fact patterns have been sustained in the courts using the above report as a guide. The significance of the case lies in the Court's acceptance of the analysis of purported development fees and determination of proper tax treatment.

Finally, examiners should be aware that there are regulations which address situations where a developer fee is made upon the sale of a completed rehab building which is then first placed in service by the new owner. In these situations, examiners can use the following law sections which treat the developer fees as added to the purchase price as costs of acquisition, not includible in the qualified Rehabilitation Tax Credit basis.

Treas. Reg. section 1.48–12(c)(3)(iii) provides examples of expenses incurred by the taxpayer for purposes of qualified rehabilitation expenditures.

Sample Report

FORM 886-A EXPLANATION OF ITEMS

General Background/Facts

Historic Associates Partnership started on October 15,1990, per the 1990 partnership return and the partnership agreement as submitted during audit. Per the 1990 partnership return, there are 33 partners in Historic Associates. The partnership is a limited partnership and the sole general partner is "X." "X" has also been designated as the Tax Matters Partner per the partnership agreement, and based on recent correspondence, that Tax Matters Partner designation remains currently in force and effect.

The Offering Memorandum indicates that Historic Associates is a partnership formed under Pennsylvania law to acquire a four story building in the Old City Historic District of Philadelphia, Pennsylvania. The partnership rehabilitated the structure into 42 luxury apartments and 8,000 square feet of commercial space. Per the Offering Memorandum and background obtained during the audit, the partnership intended to, and actually has, operated this project as an apartment rental project.

The partnership, from the outset, intended to obtain historical certification of the project's qualifying rehabilitation costs and take the 20 percent Certified Historical Rehabilitation Credit. Based on verification with the National Park Service and the Part III Certification as submitted by the partnership during audit, the rehabilitation work as performed has been "certified" by the National Park Service. As long as the costs are for "qualified rehabilitation expenditures" they can be included in the basis for the 20 percent Historical Rehabilitation Credit. Historic Associates was one of various partnerships promoted, syndicated, organized, and managed through various general partners on behalf of the "Y" Group. These partnerships were very similar in nature in that all were primarily formed to acquire, rehabilitate and subsequently rent the historic structures as residential/luxury apartments.

A major selling feature of these limited partnership interests was the 20 percent Certified Historic Rehabilitation Tax Credit available for "qualifying rehabilitation expenditures" as defined by Federal tax law and subject to the rehabilitation works approval by the National Park Service. Adding to the attractiveness of these partnerships was their leveraged nature whereby usually less than 10 percent of the purchase price of the investors limited partnership interest was required to be paid by cash, while the remaining amounts were paid by notes from the investors to the partnership and which were payable over a 5-year period.

The partnerships were also similar in that various functions and services necessary to carry out the intended purposes of the partnerships were usually performed by the many affiliates which operate under the auspices of "Y" Group. These functions included but were not limited to the following:

1. The sponsoring, syndication, and promotion of the various limited partnerships to raise the necessary capital to acquire, rehabilitate, and subsequently rent out the projects. "Y" and its affiliates were responsible for creating an investment package, (the limited partnership interests), that had an appeal to investors. Without this attractive investment package, as created and promoted by "Y," the functions performed by "X" as indicated below would be impossible to accomplish.

   After creation and formation of the various partnership investment vehicles it was then necessary to seek out and engage various broker/dealers capable of selling these investments to the ultimate limited partner/investors throughout the country. Once engaged, "Y" had to mobilize these broker/dealers to sell the units and complete syndication of the respective limited partnerships.

   One of the company's strengths was the creation of partnerships that had appeal to investors. Their staff had to communicate the merits of their programs. The limited partnerships were marketed through stock brokers, insurance agents, and financial planners who then communicate with and sell the partnership units to the investing public.

   "Y," through its employees, had to educate the registered securities dealers of the benefits of investing in the limited partnerships in addition to the economic and tax incentives. Additionally, for the later year projects, the company had a "Due Diligence Office" which provided detailed financial and tax information to broker/dealers on all more recent offerings.

   As indicated above, a substantial amount of time and work was invested in the creation of the investment package and the subsequent promotion, syndication, and sale of these limited partnership investments by "Y."

2. The placement of a general partner for the various partnerships to act in the capacity of, and to perform the normal functions and duties of general partner. In

this fiduciary role as general partner, the individuals or entities who acted as general partners had the exclusive right to manage the business affairs of the partnership. In most of the promotions, the general partners were either "key employees"/owners of "Y," entities owned by "key employees"/owners of "Y," or shared some "affiliation" with the "key employees"/owners of "Y" and usually acted under the guidance of "Y" in their role as general partner.

3. The work necessary to "organize" the partnership which was more in the nature of an expenditure in relation to the creation of the partnership than of an expenditure relating to the carrying on of the intended business operations or "day-to-day business" of the partnership.

4. The "acquisitional" work necessary by "Y" and its "affiliates" to find potential buildings and perform economic and feasibility studies of the buildings, and their general market areas including phone and on-site type reviews, and analysis, negotiations by "Y" and its affiliates on behalf of the partnerships for the purchase of the land and buildings, the settlements/closings on the ultimately selected land and buildings, and the work necessary to maintain, manage, and hold such land and buildings until the rehabilitation is commenced by a developer on behalf of the partnership.

5. The formation/engagement of a developer entity to directly perform (or to subjugate to an affiliate in order to have performed) the necessary development work performed for the rehabilitation of the "Historically Certified" building owned by the particular partnership. This development work/contract usually includes a commitment of the various "Y" entities to effect the rehabilitation and renovation of the particular project owned by the partnership under audit. The development agreements are usually "Turn Key" in nature and for a fixed price the "developer" will arrange for, manage, and pay for the construction and completion of the rehabilitation and renovations planned for the particular project. In all of the examined partnerships, the identified "developer entities" were determined to be owned by individuals or entities which were also determined to have been "Key Employees" or owners of "Y."

6. Two additional services included as "developer fees" were "Cash Flow Guarantees" and "Investor Surety." While outside unrelated sureties were engaged to guarantee the payment of the "Limited Partners Investor Notes" for a non-refundable premium price, the "Cash Flow Guarantees" were provided by an entity which was an affiliate of "Y." These affiliates would, for a set price, guarantee to lend to the particular partnership the cash amounts necessary to pay the obligations of the partnership under particular notes or, in some promotions, the guarantee was limited to a particular dollar amount.

7. A final category which appeared in the partnerships or promotions was the use of an affiliate of "Y" as manager of the subsequent rental operations of the particular projects as the buildings became available to be "placed in service." These management agreements usually addressed renting, leasing, operating, and managing the projects for various commissions based on gross annual rentals.

   Additional incentives were paid for re-rentals and renewals at the various apartment buildings.

Additional Facts

NOTE: The preceding pages included general facts and background regarding both Historic Associates and the promoter "Y." Additional facts will address the dates, amounts, and specifics regarding the transactions entered into by the partnership during the acquisition and rehabilitation phase of the project.

All of the information presented below was obtained during the examination through review of the Offering Memorandum, the books and records, legal documents (including but not limited to the Settlement Sheet for the acquisition of the property/shell), the"Development Agreement," "Development Note, "Partnership Agreement, AIA (American Institute of Architects) Application and Certificate for Payment, Statement/Certificate of Occupancy, the first lease executed after completion for occupancy, National Park Service application and responses Parts I, II, and III which verify the Historical Certification of the rehabilitation work on the particular project, and any oral testimony as presented by attorneys or accountants acting as Powers of Attorney for the examined partnership, and officers or employees of the "Y" organization.

– The partnership name is Historic Associates and is located in Philadelphia. The rehabilitated building is also located in Philadelphia. The building shell was purchased September 6, 1990. The purchase price of the shell was: $600,000, ($400,000 as cash and $200,000 as seller take back mortgage from a bank).

– The developer entity is known as Development Company. The ownership of Development Company is as follows:

  65% – Apartments Inc. (100 percent Owned By "Z")
  15% – "X" (Current General Partner Of Historic Associates)
  15% – "A" (Key Employee of "Y")
  5% – "B" (Key Employee of "Y")

- The development contract is a "Turn Key Contract" and the amount is $3,600,000 with $750,000 to be paid in cash while the remainder of $2,850,000 will be paid by note (development note).

- The rehabilitation expenditures, reflected as basis for the Rehabilitation Tax Credit, have been tied to the books and records and verified by documents submitted during the audit. Based on all items as submitted, and information obtained during the audit, the examining revenue agent isolated "non-qualifying" items. The "Fact, Law and Argument" presentation follows:

Issue

Whether Syndication Expenses in the amount of $650,000 are includible in the "Qualified Rehabilitation Basis" for purposes of The Historic Rehabilitation Tax Credit and for depreciation basis purposes.

Law

Tax Treatment of Syndication and Organization Expenses. Under IRC section 709, the following treatment is applied to organization and syndication fees.

Extract

SEC. 709 TREATMENT OF ORGANIZATION AND SYNDICATION FEES.

(a) GENERAL RULE. — Except as provided in subsection (b), no deduction shall be allowed under this chapter to the partnership or to any partner for any amounts paid or incurred to organize a partnership or to promote the sale of (or to sell) an interest in such partnership.

(b) AMORTIZATION OF ORGANIZATION FEES. —

(1) DEDUCTION. — Amounts paid or incurred to organize a partnership may, at the election of the partnership (made in accordance with regulations prescribed by the secretary), be treated as deferred expenses and shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the partnership (beginning with the month in which the partnership begins business), or if the partnership is liquidated before the end of such 60 month period, such deferred expenses (to the extent not

deducted under this section) may be deducted to the extent provided in section 165.

(2) ORGANIZATIONAL EXPENSES DEFINED. — The organizational expenses to which paragraph (1) applies, are expenditures which –

(A) are incident to the creation of the partnership;

(B) are chargeable to capital account; and

(C) are of a character which if expended incident to the creation of a partnership having an ascertainable life, would be amortized over such life.

Under Treas. Reg. sections 1.709–1 and 1.709–2, the following treatment is applied to organization and syndication fees.

Extract

Treas. Reg. section 1.709–1

Treatment of Organization and Syndication Costs. — (a) General Rule. Except as provided in paragraph (b) of this section, no deduction shall be allowed under Chapter 1 of the code to a partnership or to any partner for any amounts paid or incurred, directly or indirectly, in partnership taxable years beginning after December 31, l975, to organize a partnership, or to promote the sale of, or to sell, an interest in the partnership.

(b) Amortization of organization expenses. (1) Under section 709(b) of the code, a partnership may elect to treat its organizational expenses (as defined in IRC section 709(b)(2) and in 1.709–2 (a)) paid or incurred in partnership taxable years beginning after December 31, l976, as deferred expenses. If a partnership elects to amortize organizational expenses, it must select a period of not less than 60 months, over which the partnership will amortize all such expenses on a straight line basis. This period must begin with the month in which the partnership begins business (as determined under l.709–2 (c)). However, in the case of a partnership on the cash receipts and disbursements method of accounting, no deduction shall be allowed for a taxable year with respect to any such expenses which would have been deductible under section 709(b) in a prior taxable year if the expenses have been paid are deductible in the year of payment. The election is irrevocable and the period selected by the partnership in making its election may not be subsequently changed.

(2) If there is a winding up and complete liquidation of the partnership prior to the end of the amortization period, the unamortized amount of organizational expenses is a partnership deduction in its final taxable year to the extent provided under section 165 (relating to losses). However, there is no partnership deduction with respect to capitalized syndication expenses.

(c) *** The election to amortize organizational expenses provided by section 709(b) shall be made by attaching a statement to the partnerships return of income for the taxable year in which the partnership begins business. *** In the case of a partnership which begins business in a taxable year that ends after March 31, 1983, the original return and statement must be filed (and the election made) not later than the date prescribed by law for filing the return (including any extensions of time) for that taxable year. Once an election has been made, an amended return (or returns) and statement (or statements) may be filed to include any organizational expenses not included in the partnerships original return and statement.

Extract

Treas. Reg. section 1.709–2

Definitions. — (a) Organizational expenses. Section 709(b)(2) of the Internal Revenue Code defines organizational expenses as expenses which:

(1) are incident to the creation of a partnership;

(2) are chargeable to capital account; and

(3) are of a character which, if expended incident to the creation of a partnership having an ascertainable life, would (but for section 709(a) be amortized over such life.

An expenditure which fails to meet one or more of these three tests does not qualify as an organizational expense for purposes of section 709(b) and this section. To satisfy the statutory requirement described in paragraph (a)(1) of this section, the expense must be incurred during the period beginning at a point which is a reasonable time before the partnership begins business and ending with the date prescribed by law for filing the partnership return (determined without regard to any extensions of time) for the taxable year the partnership begins business. In addition, the expenses must be for creation of the partnership and not for operation or starting operation of the partnership trade or business. To satisfy the statutory requirement described in paragraph (a)(3) of this section, the expense must be for an item of a nature normally expected to benefit the partnership throughout the entire life of the partnership. The following are examples of organizational expenses within the meaning of section 709 and this section: Legal fees for services incident to the organization of the partnership, such as negotiation and preparation of a partnership agreement; accounting fees for services incident to the organization of the partnership; and filing fees. The following are examples of expenses that are not organizational expenses within the meaning of section 709 and this section (regardless of how the partnership characterizes them): Expenses connected with acquiring assets for the partnership or transferring assets to the partnership; expenses connected with the admission or removal of partners other than at the time the partnership is first organized; expenses connected with a contract relating to the operation of the partnership trade or business (even where the contract is between the partnership and one of its members); and syndication expenses.

(b) Syndication expenses. Syndication expenses are expenses connected with the issuing and marketing of interests in the partnership. Examples of syndication expenses are brokerage fees; registration fees; legal fees of the underwriter or placement agent and the issuer (the general partner or the partnership) for securities advice and for advice pertaining to the adequacy of tax disclosures in the prospectus or placement memorandum for securities law purposes; accounting fees for preparation of representations to be included in the offering materials; and printing costs of the prospectus, placement memorandum, and other selling and promotional materials. These expenses are not subject to the election under section 709(b) and must be capitalized.

(c) Beginning business. The determination of the date a partnership begins business for purposes of section 709 presents a question of fact that must be determined in each case in light of all the circumstances of the particular case. Ordinarily a partnership begins business when it starts the business operation for which it was organized. The mere signing of a partnership agreement is not alone sufficient to show the beginning of business. If the activities of the partnership have advanced to the extent necessary to establish the nature of its business operations, it will be deemed to have begun business. Accordingly the acquisition of operating assets which are necessary to the type of business contemplated may constitute beginning business for these purposes. The term "operating assets", as used herein, means assets that are in a state of readiness to be placed in service within a reasonable period following their acquisition.

Revenue Rulings and Applicable Court Cases

Revenue Ruling 81–153, 1981–1 C.B. 387, states the following: An investor in a limited partnership may not deduct that part of the purchase price that is paid, through a rebate or discount arrangement, by the investor to a tax advisor on behalf of the partnership for services related to the sale of the partnership interest. The partnership may not amortize this amount under IRC section 709(b). The investors basis in the partnership is the amount of cash contributed.

Revenue Ruling 85–32, 1985–1 C.B. 186, states the following: Syndication costs incurred in connection with the sale of limited partnership interests are chargeable by the partnership to a capital account and cannot be amortized.

In *G. E. Vandenhoff,* 53 TCM 271, T.C. Memo. 1987–116 and *L. Isenberg,* 53 TCM 946, T.C. Memo. 1987–269, guaranteed payments by a motion picture partnership to the general partners was in the nature of a syndication expense and was required to be capitalized.

In *M. Schwartz*, 54 TCM 11, T.C. Memo. 1987–381, payments made to a partner were syndication expenses that must be capitalized and were not deductible as guaranteed payments.

In *G. H. Driggs*, 87 T.C., No. 46, it was found that amounts paid to a general partner as "sponsors fees" were not deductible because the partnership failed to prove whether the expenses were for syndication fees or for organization costs.

In *V. Finoli*, 86 T.C. 697, it was determined that amounts paid for preparation of a tax opinion, incurred to promote or facilitate the sale of partnership interests, and commissions and consulting fees constituted non-deductible syndication expenses.

In *A. B. Surloff,* 81 T.C. 210, fees paid to an attorney by partnerships mainly for the preparation of a tax opinion letter that was used in a prospectus given to potential investors were syndication expenses and had to be capitalized.

In *G. T. Flower*, 80 T.C. 914, it was determined that expenditures for tax advice were incurred for purposes of obtaining the tax opinion letter that accompanied organization and sales promotion of limited partnership interests and were nondeductible capital expenditures.

In *N. Tolwinsky*, 86 T.C. 1009, and *W. J. Law*, 86 T.C. 1065, it was found that organizational expenses for a motion picture tax shelter were amortizable only to the extent that such expenses were substantiated.

In *R.P. Wendland*, 79 T.C. 335, it was determined that legal expenses paid to a law firm by a coal mining tax shelter partnership constituted organizational expenses that had to be capitalized in the absence of evidence allocating such expenses between legal advice and tax advice.

In *J. K. Johnsen*, 83 T.C. 103, it was found that a partner could not deduct his share of claimed expenses for legal and tax advice because the evidence showed that the services concerned the organization and promotion of the partnership.

In *W. T. Golf*, 87 T.C., No. 2, it was held that a partnership could not currently deduct organization and syndication costs by indirectly paying them to a partner under the guise of management fees. Since no election was made by the partnership, no amortization of partnership organization expenses was allowed.

In *T. J. Darken*, 87 T.C. 1329, the court ruled that payments made by a partnership to two general partners for services were for expenses in connection with organizing the partnership and the offering and such payments were not currently deductible as guaranteed payments. The partnership was entitled to amortize the expenses.

In *T. Collins*, 53 TCM 873, T.C. Memo. 1987–259, it was found that management and consulting fees paid shortly after the formation of a general partnership were held to be organizational expenses and were required to be amortized rather than currently deducted. Similarly, legal and accounting fees incurred shortly after formation were nondeductible organization and syndication expenses.

Revenue Ruling 88–4, IRB 1988–3. It states that the fee paid by a syndicated limited partnership for the tax opinion used in the partnerships prospectus is a syndication expense chargeable by the partnership to a capital account and cannot be amortized.

Argument and Conclusion

Syndication Expenses have been adjusted as follows: Development Contract of $650,000 has been recharacterized as Syndication Expense, and as such is not includible in either the depreciable basis nor the "qualified rehabilitation expenditures" for purposes of the Historic Rehabilitation Tax Credit.

The promoter of the examined partnership was "Y" and its related and affiliated entities. Their primary function as sponsor, syndicator, and promoter of the various partnerships they syndicated was necessary to raise the required capital to acquire, rehabilitate, and subsequently place the projects in service. "Y" and its affiliates created an investment package and "trained" various brokers/dealers to sell the units to the ultimate limited partner investors. "Y" had an in-house "Investment Marketing Division" and "Syndications Department" which were responsible for sponsoring, syndicating, and promoting their partnerships. A substantial amount of time was expended to create, syndicate, and market these investment packages or limited partnership units. Additionally, the primary source of compensation for these services are the development contracts as entered into with Historic Associates.

It has been determined, for the partnership Historic Associates, that the amounts as specified above were attributable to the "syndicating aspects" of the project and as such these costs have been recharacterized to reflect their proper tax treatment.

Taxpayers Position

The Tax Matters Partners have indicated they are in agreement with the adjustments as presented on this report.

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Chapter 20

PASSIVE ACTIVITY RESTRICTIONS

BACKGROUND

The Tax Reform Act of 1986 introduced tax law changes which indirectly impacted the rehabilitation credits. One of these changes, the "Passive Activity Provision,"was intended to stop "abusive tax shelters." Although not directly related, these changes have impacted on the availability of the credit to certain types of investors. As a result, the main effect of the passive activity restrictions has been a significant change in the character of the users from the partnership form to other forms of ownership.

Modifications to the Passive Activity provisions under the Omnibus Budget Reconciliation Act of 1993, (effective for taxable years after December 31, 1993), provides some relief. The Act provides that deductions and credits, from rental real estate in which an eligible taxpayer materially participates, are not subject to limitation under the passive loss rules. An individual taxpayer is eligible if more than one-half of the taxpayer business services for the taxable year, amounting to more than 750 hours of services, are performed in real property trades or business in which the taxpayer materially participates.

There have been several other proposals to alter the passive activity restrictions in regard to rehabilitation credits. Any legislation which restores the investors' ability to use rehabilitation tax credits will likely result in an increased number of projects. This potential increase would result because the rehabilitation industry built a significant "partnership" investor base prior to the Tax Reform Act of 1986 which was almost completely eliminated by the passive activity restrictions. The industry now includes corporations, individual owner-occupied businesses, and particularly, the low income housing projects to create affordable housing. If legislation is enacted which reduces or eliminates the effects of the passive activity restrictions, the industry would again be "attractive" to all types of investors.

PASSIVE ACTIVITY PROVISIONS

Refer to IRC section 469.

IRC section 469(a) and (b) - Passive Activity Losses and Credits Limited

IRC section 469(i)(3) -- Phase out of Exemption

IRC section 469(i)(6) covers active participation not required for rehabilitation credit.

IRC section 469(m) covers phase-in of disallowance of credits for pre-enactment interests.

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Chapter 21

SYNOPSIS OF LOW INCOME HOUSING CREDIT PROVISIONS

BACKGROUND

The following synopsis is intended to provide an overview of the Low Income Housing provisions. This is necessary because of the changing nature of taxpayers claiming the Rehabilitation Tax Credit to include project owners who also intend to create affordable housing. These taxpayers will qualify for both the Rehabilitation Tax Credit and the Low Income Housing Credit (LIHC).

The Low Income Housing Credit is currently available under section 42 of the Internal Revenue Code of 1986. This credit is available to owners of buildings as an incentive to rehabilitate affordable multi-family housing for occupants who meet specific income requirements. The credit is available for up to 10 years as long as the project remains in compliance with the occupants' income limitations. To fully attain the credit, the "low income housing" portion of a building must remain in service with qualified occupants for 15 years. Under current tax law, an investor/owner can generally take approximately $7,000 of tax credit in a given year, (depending on their individual tax situation). In some cases, the taxpayer, the owners may also benefit from the use of the Historical Rehabilitation Tax Credit if the Low Income Housing project also meets the criteria established by the Department of the Interior, National Park Service.

PROVISIONS REGARDING LOW INCOME HOUSING

To qualify as low income housing for purposes of the LIHC, the property must be residential rental use property. This could be either multiple buildings, an entire building, or a portion of a building through allocation, (a mixed-use building with commercial and residential use/tenants). The units must be generally available to the public, and be consistent with HUD rules and regulations. Units, generally may not be used as transient housing or be a cooperative corporation.

INCOME TARGETING

For a building to qualify as low income housing, one of several income targets must be met regarding the tenants:

1. at least 20 percent of the rental units must be rented to tenants with qualifying income at or below 50 percent of "area median income," or

2. at least 40 percent of the rental units must be rented to tenants with qualifying income at or below 60 percent of "area median income," or

3. at least 15 percent of the rental units must be rented to tenants with qualifying income at or below 40 percent of the "area median income." In addition, the rent for the tenants that are not low income must be at least 200 percent of the average rent charged to low income tenants for a comparable unit.

NOTE: Owners must make an election by the time the building is placed in service. This election stays in effect for the entire 15 year period and is irrevocable.

ALLOWABLE CREDIT PERCENTAGES

Generally, the credit is taken in each of 10 years as long as the building/units continue to qualify based on the income targeting restrictions. The credit amount/rate is determined as follows:

1. 70 percent present value credit for new construction or rehabilitation. The rehabilitation must be substantial and meet on one of the two following tests:

   a. owners must incur the greater of 10 percent of the adjusted basis at the beginning of a 24 month test period, or

   b. $3,000 for each unit.

NOTE: If federally subsidized, the 70 percent present value credit is not available to the extent of the subsidy. Owners may either reduce their basis by the amount of the subsidy and take the 70 percent present value credit on the remainder or include the subsidy amounts with the qualified basis but limit the credit to the 30 percent present value credit (explanation below).

2. 30 percent present value credit for the cost of building acquisition and also for federally subsidized amounts. As indicated above, the owner does have the option to remove the federal subsidy amounts from the qualifying basis and take the 70 percent present value credit on the non-federal subsidy.

NOTE: The yearly credits, based on the present value, are approximately 9 percent per year for the 70 percent Present Value Credit and approximately 4 percent per year for the 30 percent Present Value Credit. These percentages are adjusted monthly through Revenue Rulings and will be dependent on the respective month and year the property is placed in service.

WHEN THE CREDIT MAY BE CLAIMED

The owner(s) of the building(s) qualifying for the LIHC are eligible to take the credit as follows:

1. for the period of 10 taxable years beginning in either the taxable year in which the building is placed in service, or

2. at the election of the owner, the credit may be taken in the year following the year placed in service.

NOTE: The building must be a "qualified" low income building as of the first taxable year above.

EFFECTS OF FEDERAL GRANTS

Eligible basis must be reduced by federal grants. If, in any year of the 15 year compliance period, a grant is made with respect to either the building or the operation of the building and any portion of such grant is funded with federal funds, the eligible basis of such building for such taxable year, and all succeeding taxable years, shall be reduced to the extent of such grant.

NOTE: The above relates to federal grants either disbursed directly to the owners or indirectly through state or local governments. Also note that the federal funds must be in the form of a grant when given to the owner in order to be excluded. If a federal grant was given to a state or local government which then created a loan program for owners, then this would not be treated as a federal grant but as a federal loan.

EFFECTS OF LOANS/FEDERAL SUBSIDY

Projects are considered "federally subsidized" if there is, or was, any obligations outstanding which carry interest which is exempt from taxation under section 103 of the Internal Revenue Code, (interest on state and local bonds). Additionally, projects are considered "federally subsidized" if any below-market federal loans are used to finance any of the project if the proceeds were used (directly or indirectly) with respect to the building or the operation thereof. If tax-exempt financing or below-market federal loans are involved, then two options are available. The owner(s) may:

1. remove all tax-exempt financing and below-market federal loans from the basis of the property and claim the 70 percent Present Value Credit on the remaining basis (approximately 9 percent per year for 10 years), or

2. leave all tax-exempt financing and below-market federal loans in the eligible basis and take the 30 percent Present Value Credit on the entire basis (approximately 4 percent per year for 10 years).

NOTE: "Below-market federal loans" are any loans funded, in whole or in part, with federal funds if the interest on such loans is less than the "Applicable Federal Rate" (AFR) in effect under IRC section 1274(d) as of the date the loan was made. Below-market federal loans by reason of assistance under IRC section 106, 107 or 108 of the Housing and Community Development Act of 1974 (as in effect in 1986) are not included in the above.

RECAPTURE PROVISIONS

The credit is recaptured based on situations where the qualified basis in a given year is less than the qualified basis of the preceding year. The owner(s)/investor(s) tax will be increased by the credit recapture amount.

The credit is recaptured as follows:

(1) (2) (3) (4)
(30,000 – 20,000) x 5 Years = 50,000 (recapture)

(1) represents the actual credit allowed/claimed per year.

(2) represents the credit which would be allowed (per year) if the credit had been taken over the 15 year compliance period.

(3) represents the number of prior years the credit was already claimed. NOTE: There is no credit allowed for the current year or any future year unless the building again qualifies.

(4) represents the recapture amount and also the accelerated portion of the credit. The accelerated portion is the difference between the credit if allowed over the 15 year compliance period and the credit taken yearly over the 10 year credit period. The difference is then multiplied by the number of years the credit was claimed since the property was placed in service.

STATE HOUSING CREDIT CEILING

The state housing credit ceiling applicable to any state for any calendar year shall be an amount equal to the sum of:

1. $1.25 multiplied by the state's population,

2. the unused State Housing Credit Ceiling (if any) of such state for the preceding calendar year,

3. the amount of State Housing Credit Ceiling returned in the calendar year, plus

4. the additional amount (if any) allocated to such state by the Secretary of the Treasury.

LOW INCOME HOUSING CREDIT CLAIMED IN CONJUNCTION WITH THE REHABILITATION TAX CREDIT

If a project has both the intent of historical rehabilitation and the creation of affordable housing, then the owners can potentially qualify for both the Low Income Housing Credit and the Historic Rehabilitation Tax Credit. As there are separate and independent provisions for each of these credits, all the requirements for each credit must be met, as well as the computational correctness of the amounts claimed.

After determining the qualified basis for the Historic Rehabilitation Tax Credit and reducing the basis of the qualified expenses by the full amount credit taken, the owner can determine what the correct Low Income Housing Credit should be. After reduction for the amount of the Rehabilitation Tax Credit, the remaining basis will qualify for the 70 percent Present Value Low Income Housing Credit. Further reduction of the remaining basis would be required if either federal grants or below-market loans were used to finance the rehabilitation.

Treatment of acquisition costs differ for the two credits. For purposes of the Rehabilitation Tax Credit, acquisition costs are excluded from the qualified basis; acquisition costs are recognized for purposes of the 30 percent Present Value Low Income Housing Credit. The 30 percent LIHC is also used as an alternative method for including federally subsidized loans or tax exempt financing.

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Chapter 22

CONSIDERATION OF PENALTIES

BACKGROUND

As with all examination cases, it is important to consider applicable penalties based on the facts and circumstances of the individual case. However, based on the technical nature of the issues, and potential confusion because the taxpayer must also interact with the State Historic Preservation Office and the National Park Service, assertion of penalties for most cases is not recommended. The National Park Service has "standards for rehabilitation" which must be met, and both the "standards," and the procedures implemented to process the cases with the National Park Service and the State Historic Preservation Office can create many practical dilemmas when viewed from a tax law perspective.

Good examples of cases where assertion of penalties are being recommended are older cases lacking historical certification of the rehabilitation and instances where the "30 Month Rule" has not been complied. In these cases, assertion of the following penalties is recommended:

1. Negligence Penalty under IRC section 6653(a) which includes 5 percent of the underpayment, and an amount equal to 50 percent of the interest payable under IRC section 6601.

2. Substantial Understatement Penalty under IRC section 6661 adding to the tax an amount equal to 25 percent of the amount attributable to such understatement.

3. Interest on Substantial Understatements Attributable to Tax Motivated Transactions under IRC section 6621(c) would provide for interest at a rate of 120 percent of the underpayment rate on substantial underpayments attributable tax motivated transactions.

NOTE: These penalties have been adapted over recent tax changes including the following:

1. The negligence penalty is now under IRC section 6662(b)(1), for returns the due date for which (determined without regard to extensions) is after December 31, 1989. Also note that the interest portion of the negligence penalty has been deleted completely with returns due after December 31, 1987 and with the "Accuracy Related Penalties" under the newer sections.

2. The Substantial Understatement Penalty is now under IRC section 6662(b)(2) for returns the due date for which (determined without regard to extensions) is after December 31, 1989.

3. Interest on Substantial Underpayments attributable to Tax Motivated Transactions has been repealed for returns the due date for which (determined without regard to extensions) is after December 31, 1989.